Country Development Strategy Statement

FY1985



Egypt

January 1983

Agency for International Development Washington, D.C. 20523

BEST AVAILABLE DOCUMENT

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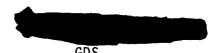


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USAID/CAIRO

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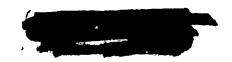
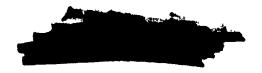
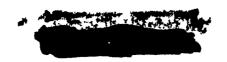


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Mission Director's Overview

This year's CDSS builds on a body of experience and analysis developed and financed by A.I.D. over seven years of operation in Egypt. The resulting information has shaped the strategic thinking of the Mission and the Agency and has increasingly influenced Egyptian planning.

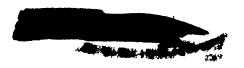
As a newcomer, I have been able to weigh the conclusions of the CDSS exercise against relatively fresh impressions of the country and its prospects. Impressions change or prove faulty, and I expect, and even hope, that some of mine may be modified. Nevertheless, I have been struck by the general coincidence between the information base on which the CDSS is built and my own less theoretical conclusions. Some of these impressions follow and constitute my own introduction to the CDSS.

An impression is the mind's first and immediate effect of an experience or perception. An impression, therefore, does not provide for any amelioration from the perspective of history or from the outlook of the future. In that sense, the impressions that I record may appear too harsh, for they neither take into account the circumstances giving rise to the 1952 Revolution and the events that followed, nor the ambitious and constructive plans for the future that recently have been issued by the Government of Egypt and that, if successfully implemented, will result in improvement of many social and political conditions. The Egypt I describe is not cast in concrete and is not the country that will endure forever; to that extent, impressions may well be transient.

To be in the development business in Eypt requires a measure of optimism, and I can honestly say that, despite what may appear to be the negative tone of my impressions, I have that necessary ingredient. In adding it to the AID mix in Egypt, however, it is necessary to maintain a balanced view and not let developmental optimism prevail in an unalloyed form. The alloy is the Overview. The optimism is clearly identified in the body of the CDSS. The CDSS details at great length the measure of the developmental problems in Egypt and at the same time proposes constructive AID responses. These impressions, therefore, although they are intended to provide an introduction, cannot be read as a separate free-standing series of notes; they must be read in conjunction with the CDSS itself.

Infrastructure

Urban infrastructure throughout Egypt is falling apart. Most of it was built around the turn of the century. Capital appropriations for repair and rehabilitation during the last twenty years have been negligible. Sewers, waterlines, roads, bridges, culverts, drains, and an unending facade of decaying buildings and structures give sombre evidence of the pervasiveness of the collapse. New construction, whether residential or commercial, seems within weeks to be dilapidated. Nothing ever looks new; everything is instant decrepitude. Infrastructure is in free-fall.





The newcomer must try to relate A.I.D. activities to this tragedy. What is the merit of a research program in nutrition if there are no aseptic surroundings in which food can be prepared, eaten, and disposed of, or of a new power plant if the industrial structure consuming the power receives nothing in support from the broader web of services on which industry must depend?

Population

Egypt's rapidly increasing population is exerting dangerous pressure on the social structure of the country. Whatever success family planning programs have had and may have, new births in the last decade have ensured that these problems will continue to exist and worsen for the next thirty years. Egypt's population today is well over 45 million people, having more than doubled since 1950. It is growing by about 100,000 per month, 1.2 million each year, the rate of annual increase hovering around 2.7%.

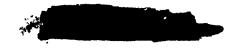
With not more that 4% of the land reasonably able to sustain cultivation, Egypt has one of the world's highest population densities in relation to arable land. An additional 400,000 people will live on that land each year, but the real increase will occur in the cities, where a further 800,000 will have to be accommodated each year. More than 300,000 of this urban influx will settle in Greater Cairo.

In company with others, A.I.D. has influenced population policy in Egypt. It has done so not by hypothesizing a specific decline in the population growth rate, but by demonstrating its importance to Egyptian development while simultaneously providing resources. A.I.D. has emphasized the carrot, not the stick, in this sensitive policy area and with some success. There are lessons learned here which may well be applicable to energy, utility, industry and agricultural policy. Nonetheless, the question remains: can an A.I.D. program cope with such a growing human burden?

Government Policies

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Egypt's development problems are a legacy of the transformations that have occurred in the country since World War II. In that period Egypt has endured two major transitions. The first was from a corrupt, dissolute monarchy based on widespread social and economic inequities to a Nasserist revolutionary system which lasted almost two decades and which emphasized broad social programs, a redistribution of land ownership and other forms of wealth, the ending of foreign influence and privilege, and the pursuit of Arabist ambitions at the expense of rational development objectives. Those years also were marked by repression of political dissent and expression at home, as well as by a series of disastrous and costly wars with Israel. The second transition, from the Nasser era to the Sadat/Mubarak period, lasted through most of the 1970's and into the early 1980's. It witnessed the gradual introduction of greater political and economic freedoms into Egyptian life, the reorientation of Egyptian foreign policy away from war and



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towards regional peace, and a reliance on friendships and cooperation with the West in general and the United States in particular. Only in the last few years, and especially following Hosni Mubarak's succession to power in October 1981, has the Egyptian Government finally begun effective development strategies.

Egypt's development problems are fundamentally a reflection of this history, which unfortunately has been replete with economic policy and functional mismanagement. Notwithstanding the liberalizing trends of recent years, however, GOE economic policies continue to be centrist and tightly bureaucractically controlled, verging on the autarchic. The surface manifestations of this generation of social upheavals and economic mismanagement are apparent everywhere. To cite but two examples:

- Farmers are indirectly taxed to support urban populations through price controls at the retail level and through mandatory procurements by the Government from farmers at low price levels. The results are rural poverty and much lower agricultural productivity than could be obtained if farmers could be induced economically to apply readily available and affordable technology.
- Everyone has stories about energy prices in Egypt. The prices of diesel fuel, at \$.03 per liter, and of mazout fuel, at LE 7.50 per ton (equivalent to \$.032 per gallon, whereas in the U.S. a gallon of mazout would cost about \$.70), are ludicrously low and yet they constitute a major inhibition to rational economic expansion and decision-making.

Can an A.I.D. program function in an environment of discordant and unprogressive government policies without a sophisticated approach to policy dialogue and an optimistic appraisal of dialogue reward?

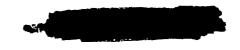
Use of Human Resources

Egyptian human resources are badly underutilized, trained for the wrong jobs, and then indifferently managed when placed in those jobs. Egypt's labor force will double during the next twenty years, with an estimated 11 million new jobs needed by the year 2000 to employ the new entrants. Where will the job opportunities emerge? During the last ten years, most new employment (possibly as much as 85%) has been in the already overstaffed government sectors. Much of that new domestic employment has been either redundant or non-productive or both. Temporary emigration to nearby OPEC countries relieved the escalating problem in the 70's, but neither the public sector nor the OPEC safety valves can be relied on in the future.

What of the human resource before it reaches the job market? Teaching standards in most disciplines, at most levels of education, are poor, reflecting inadequate teacher training, low teacher remuneration, and inadequate physical plant. Eleven major universities continue to spew out graduates who are not offered challenging employment and frequently







take jobs which are unrelated to their education. Even those who are supposedly fully qualified are often in fact poorly trained, with teaching emphasis on theory, huge classes, a lack of texts, and inadequate laboratories. The decaying quality of Egyptian education is affecting careers. Although an estimated 10,000 physicians and 3,800 nurses have emigrated to Africa and the Arab states in recent years, increasingly there is a reluctance abroad to accept Egyptian physicians who have recently received training in Egypt. Saudi Arabia will not do so, and Kuwait will only permit them to practice after a three-month remedial training program. Egypt's once proud and varied intellectual prestige is being eroded by this sort of disdain and by the constant pressure of population growth against an education structure that has had to run in order to stay in the same place and that has faced an inelastic demand for graduates from the manufacturing and productive sectors of the economy.

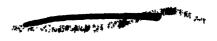
While the quality of Egyptian education declines, there is, nevertheless, strong sentiment that Egyptian professionals should and can do it all. Within the GOE and among the public sector there is growing frustration with and distrust of foreign experts and consultants. In the mid- and late-1970's, the GOE would accede to almost any suggestions A.I.D. might make with regard to U.S. consultants. The burden has now dramatically shifted, so that A.I.D. must show a compelling need for consulting services and that Egyptians cannot do the job. Given the performance levels of some U.S. consultants in Egypt and the sheer size of the U.S. consulting presence, with its accompanying disruptive, albeit usually normal, turnover cycles, the frustration and distrust are understandable, but the fact remains that Egyptians do not yet have world-standard training, experience, and competence, particularly insofar as management is concerned.

How can A.I.D. improve the utilization of a human resource available in such quantity and with such innate competence?

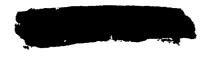
Productivity

The absence of quality standards applicable to all sectors of Egyptian life is noteworthy. There is a pervasive lack of pride in work standards and work accomplishment. Quality standards are affected by the way people approach their jobs. With decent jobs scarce and a long tradition of superior/subordinate relationships, a subordinate has little to gain from taking risks. The product is a docile employee not interested in initiating action.

Public sector companies are run predominantly by engineers and chemists, professionals concerned most with production and processes, not management, finance, the marketplace, or the consumer. Cooperation with other companies to meet government-imposed production targets (goals which are directly linked to remuneration) governs the behavior of the public sector. It is understandable but deplorable that few managers are ready to complain about the performance of colleagues or the design and function of the goods produced.



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There are three major categories of professional competence in Egypt:

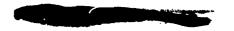
- Outstanding performers, the cream that rises to the top in any society, driven by intellectual endowment, ambition, love of country, power and prestige; this is the small group that runs Egypt.
- Competent professional performers, a minority of reasonably well educated persons, most of whom emigrate or aspire to overseas employment and living standards; this is the group that Egypt misses and should contrive to retain.
- Indifferent professional performers, the majority of educated persons, whose drive and energy, if they exist at all, have been atrophied by Egypt's numbing bureaucracy and lack of professional challenge; this is the group that constitutes a large dissatisfied social mass and sees little change in its standard of living and little change likely to materialize.

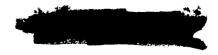
While the human inputs and management are perhaps the most striking Egyptian productivity deficiencies, the country's capital resources are not sufficient to offset the human inadequacies. Capital equipment in Egyptian manufacturing plants is obsolete. Manufacturing processes are frequently outmoded and, in many cases, were so when they were originally installed. Wide technological gaps exist between manufacturing capability in Egyptian industry and industry in other manufacturing centers, and only artificialities (e.g., government subsidies) gloss over these deficiencies. Egypt has failed to take advantage of production areas of economic advantage, particularly in the agricultural sector. There is generally a lack of economic orientation or incentive.

How can A.I.D. contribute to an improvement of the product of human labor in the face of what appears to be structural employment stagnation, and what role should A.I.D. play in the re-equipment of Egypt's capital plant?

The Private Sector

Despite the innate vitality of individual entrepreneurship, the reality of private sector growth in Egypt is that it will be inhibited as long as central government policy disincentives continue and no attempt is made to coalesce private and public sector policies. Although private sector activities may constitute as much as 30% of the industrial production, the Egyptian private sector presence is not very significant if investment in banking and oil is eliminated. Banks themselves have had to take the lead role in private sector capital investment, replacing individuals, since the private sector in Egypt has not by any means recovered from its experience in the Nasser era when assets were seized and it was relegated to retail trade, handicrafts, repair services, housing and agriculture. Today, big Egyptian private investors put their money into urban real estate (and, in a few cases, into large farms), but not often enough into productive activities.





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Foreign investors have done much the same, despite the Open Door Policy and frequent pronouncements of GOE interest in foreign investment. Without passing judgment on whether performance should have been better there has only been somewhat over \$200 million of U.S. investment in all sectors, including oil, since the "door" swung open.

Realistically speaking, no private entrepreneur is going to accept capital risk in the face of government policies that keep the private sector in second-class status, and second-class status is what most investors, at least foreign investors, discern when they scrutinize the structure of the Egyptian private sector.

If economic growth is related to a productive and creative private sector and an encouraging environment for entrepreneurs, how can A.I.D. nourish the appropriate conditions and policies in Egypt?

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Egypt's development problems can be solved. They were created by policies, and they can be reversed by a fresh set of policies.

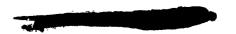
The most critical policy changes are in the areas of pricing and public/private regulatory regimes. No country can develop if it doesn't have prices that reflect true costs. Equally, no country can develop if it has bound itself up into a knot of conflicting regulations that increasingly serve neither equity nor efficiency objectives. Most important of all, the solution to Egypt's development problems is not simply to throw resources at the surface manifestations of the problems, the country's deteriorated capital stock. The resource transfers must be accompanied by solutions to the policy issues that have created the needs for the resource transfers themselves. The CDSS presents a strategy that is based on those realities.

I have noted the six major development problems that have struck me most forcibly since my arrival last September:

- -- Infrastructure Decay
- -- Population Pressure
- -- Government Policies
- -- Use of Human Resources
- -- Productivity
- -- Private Enterprise

These seem to be the core problems, although there are many others (health care, research activities, ad infinitum, as in any developing country).

My comments present a gloomy assessment. Certainly Egypt today does not appear to constitute the ideal beneficiary of a \$1 billion annual assistance program. Yet there is another side of the story. One of the



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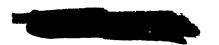


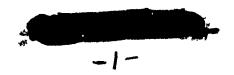
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CDSS Annexes, an important document, details certain Government of Egypt policy changes enacted during the last decade. Those changes, in total, represent progress and indicate a political awareness of the need for change and some willingness to tackle the difficult issues invoved.

The United States does not have many alternatives in Egypt in terms of administering an assistance program having its roots in political realities. It can pursue a course of policy dialogue and hope that a planned development program, carried out in conjunction with economic reform, will make Egypt a stronger country and result in Egypt exerting an even more active role in the Middle East as a close ally of the United States. I think that course and its potential rewards are worth the effort. The alternatives are skimpy. The United States could slide down the slope of cash transfer, but that alternative is in reality an economic palliative which would be unlikely to result in any lasting fundamental improvement in Egypt's ability to function well economically. There's precious little in between.

The job of bridging between the problems I note and the funding of the U.S. program is the purpose of the CDSS, and I leave to that document the responsibility to detail the premises of the program, the program itself, and the program's funding.





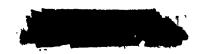
I. ANALYSIS

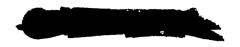
A. GENERAL COUNTRY SITUATION AND U.S. GOALS AND OBJECTIVES

1.01 U.S. economic assistance for Egypt supports two major U.S. strategic objectives. These objectives, simply stated, are (1) the consolidation and extension of the Middle East peace process, and (2) the enhancement of stability in the area as a whole. A basic premise of U.S. policy is that Egypt's own political stability is a prerequisite for its continued positive participation in the peace process, as well as for its ability to contribute to the maintenance of regional security. In short, we want a politically stable Egypt that will continue to see its interests served by a close relationship with the U.S. in pursuit of peace and area stability. An AID strategy that enhances Egypt's ability to place economic development on a self-sustaining basis is a valid and necessary means of facilitating the attainment of this highly important objective.

1. Egypt's Political/Economic Perspective

- Since his ascension to the Presidency in October 1981, President Mubarak has sought, within the framework of continued support for the Camp David accords and also relations with the U.S. to distance himself and his Government from the popularly perceived, at least in retrospect, excesses of the Sadat era: flamboyance in rhetoric and style of life, excessive promises of near term prosperity, corruption in Government and the position of being "odd man out" of the Arab fold. He has had some success in this endeavor. His style of Government is subdued rather than flamboyant. Promises of near term prosperity have been replaced by forthright discussions and emphases on Egypt's domestic economic problems. Campaigns against government corruption and excessive bureaucracy have been favorably received by the public at large even if the problems themselves remain strong and pervasive. The death of President Sadat and Sadat's direct association with Camp David have given Mubarak the opportunity to mend his fences within the Arab fold while continuing his support for the Camp David Accords. He has effectively taken advantage of this opportunity.
- 1.03 President Mubarak also has sought to make his Government a consensus Government. Both in speeches and in actions, he has attempted to gain broad based support across the whole political/economic spectrum of Egyptian society. While President Mubarak has registered some gains in this campaign, he has been notably less successful in achieving a consensus that would provide him with a popular charter for policy on the economic front. The Economic Conference that he sponsored in February 1982 produced neither a consensus on the problems nor on the solutions. He is reputed to have said that there were as many opinions as there were economists.
- 1.04 The absence of policy consensus on the economic front is well illustrated in virtually every one of Mubarak's speeches on the economy. They have been designed to appeal to the whole political/economic spectrum from those who favor greater public sector involvement in the



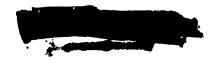


economy to those who favor a continuation and strenghening of the role of the private sector. Thus, his speeches continually affirm his support for the private sector while at the same time they reaffirm that the public sector remains the "backbone" of the economy. In one and the same breath, the costs of the subsidy system are graphically portrayed and then reaffirmed as a basis for policy. In essence, the economic consensus that Mubarak has sought to achieve has proved to be elusive. The result, on the economic front, has been sense of drift, a sense of transition to an uncertain end and a form of policy inertia. While there is a recognition of the need for policy reform, the watchword is "gradual" reform.

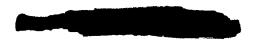
2. Implications for A.I.D. Strategy

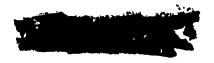
- 1.05 From the perspective of USAID, the absence of consensus on the pace and even the targets of reform has important implications.

 Mubarak's ascension to the Presidency coincided with the beginnings of a downturn in economic prospects. There is no consensus on how, or how quickly, to deal with the linkage of reduced performance prospects to a complex array of problems that are, at best, imperfectly understood. The nature of these problems and their linkages to performance prospects are discussed below. The important considerations here are the implications for AID strategy.
- Rightly or wrongly, Egypt's economic performance is associated with the U.S. presence in Egypt. Given the combination of policy inertia in the GOE and reduced prospects, it is highly likely that performance will turn downwards. Under these circumstances, there are three major strategic imperatives for AID: reduce the risks that a down turn in performance will be unfavorably associated with the U.S. presence in Egypt through a strategy that concentrates on creating physically tangible benefits to which the U.S. can point as evidence of strongly positive benefits from the U.S. presence in Egypt; promote and support GOE initiatives that stand a chance of moving policy reforms in the direction required to solve Egypt's development problems; and deflect into constructive programming channels, Egypt's desire to convert the AID program into little more than a budget/balance of payments support facility (while not precluding the possibility of such assistance if substantive policy reforms are effected by the GOE, thus creating an appropriate climate for resource transfers of this type)...
- 1.07 USAID's strategy and the political-economic framework underlying it are spelled out in detail in the sections that follow. The essential elements of the framework and strategy can, however, be summarized in the form of a few concisely stated propositions:
- Following five years of unprecedented growth in resource availability, leading to 8-9 percent real growth per annum in GDP, Egypt has re-entered a period characterized by tightened resource constraint. In essence, resources from aid and hard currency earnings from petroleum, workers remittances, the Suez Canal and tourism have reached a plateau from which it will be increasingly difficult to finance rising import requirements and growing debt service obligations on existing debt.



- -- The IMF and the World Bank share USAID's view that increased exports from the commodity producing industrial and agricultural sectors are the primary solution for arresting and then reversing the developing foreign exchange constraint. They further share USAID's views on the primary constraints to developing these export supplements. One is a cost/price structure that is massively out of line with signaling where Egypt does have comparative advantages in trade, production, consumption, and investment. A second constraint derives from efficiency-reducing differences in the regulatory regimes that apply respectively to the public and private industrial sectors.
- To date, the GOE reaction to the resource shortfall has not emphasized timely, appropriately sized corrections in the price signaling environment or regulatory liberalization. The emphasis has been on short-run expedient solutions that "buy" time on what could be expensive terms in relation to the magnitude and time-frame within which the GOE ultimately may be forced to make adjustments. These short run expedients have included increased borrowing of foreign exchange resources in short maturity ranges; reducing the overall amount of foreign exchange made available to competing public sector claimants through the foreign exchange budget; restructuring foreign exchange availability in favor of relatively immediate consumption and production needs at the expense of investment related needs; and such ad hoc measures as requiring tourists to pay hotel bills in foreign rather than domestic currency.
- -- Of obvious and immediate importance, USAID itself has been a target of the GOE as it has reacted to the developing resource shortfall. In particular, pressures have arisen to convert the AID assistance to a cash transfer program (a la the Israel program), to fund projects on an incremental as distinct from a life-of-project basis, and to place activities within a sectoral framework that would enhance program concentration, facilitate a more rapid transfer of funds between slower and faster moving sectoral subactivities, and avoid the recurrence of de-ob/re-ob problems.
- USAID sees some merit in incremental funding and considerable merit in sectorization. As such, USAID is responding positively in both these areas. Given the massive cost/price distortions in the economy, however, USAID believes that conversion of the program to a cash transfer or an increase in the cash transfer component of it (mainly CIP and P.L. 480) would, unless accompanied by substantial GOE policy reforms, only make an untenable situation last slightly longer. At best, there would only be episodic benefits from the point of view of supporting U.S. immediate and mid-term objectives in Egypt and the Middle East.
- In preference, therefore, to a cash transfer emphasis, USAID has devised a strategy that we believe (1) can deflect the cash transfer fixation, because the strategy responds explicitly and positively to GOE development priorities; (2) has lasting, politically visible benefits for the U.S.; (3) makes reasonably good economic sense; and (4) provides an opportunity to address, constructively and productively, important policy issues in the context of programming discussions and decisions.



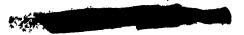


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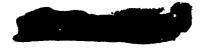
3. Results Anticipated by 1984 and 1988

1.08 If this strategy is successful -- and there are a lot of "ifs" -there will be positive benefits both for the U.S. and for Egypt. Even if policy management does not improve, the U.S. will have reduced the possibility that a downturn in Egypt's economic performance will be unfavorably associated with the U.S. presence in Egypt. There will be physical evidence to this effect to which the U.S. can point. If the U.S. also is successful in improving Egypt's policy management, Egypt will have begun to make progress in solving her development problems. This will be reflected in a gradual relaxation in the foreign exchange constraint, reduced tensions between the public and private sector and, more generally, substantive improvements in the social and economic efficiency with which resources are managed. These latter improvements will be reflected in enhanced production and employment in the commodity producing sectors and substantive improvements in the quality and quantity of infrastructure services associated with basic human needs.

- By 1984, particularly based on past U.S. investments, there will be tangible, micro level outputs to which the USAID can point. These will be in the form of physical assets constructed and operating, human resources trained and in-place, and old service systems rehabilitated and new ones in place, e.g., rural health. However, even if all parts of this strategy are successful, it is unlikely that measurably favorable policy results at a macro level will occur by 1984. There are two reasons for this. First, the improvements in performance will be overlaid on a reduced set of economic prospects -- stabilization as opposed to buoyancy in the external resources available from petroleum, workers remittances, the Suez Canal, tourism and aid. Second, policy adjustments in the pricing and regulatory regimes will, unless and even if carefully managed, upset a deeply entrenched dependence on the status quo. It will take considerable will and political skill on the part of both the GOE and the U.S. to bring off a difficult economic transition in a socially sustainable manner. The issue, however, is not whether to take the risk of trying to upset the status quo: on the basis of the resources available to Egypt, it can no longer be maintained in any case. With a measure of luck and a good deal of care, it is reasonable to project fairly substantial progress by 1988.
- 1.10 In sum, pursuing the programs we have outlined, we will have attained the following by 1988:
 - -- will have moved Egypt towards a more market-oriented economy
 - will have better equipped Egypt with a process for economic development and with the physical and human infrastructure necessary for increased production and greater productivity
 - -- will have made Egypt more self-reliant in essential foodstuffs through increases in agriculture production, attainment of greater efficiency in the use of agriculture inputs, reduction of post-harvest losses, and a greater focus on crops in which Egypt has a comparative advantage.



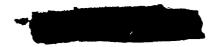


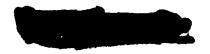


B. THE ECONOMIC SITUATION - IN PROSPECT AND IN HISTORICAL PERSPECTIVE

1. In Perspective

- 1.11 In a moment of candor, a senior official in a former Egyptian Government characterized Egypt's economic performance over the period 1978-1982 as like a "candy coated almond" sweet on the outside and, to use a word less indelicate than he himself chose, crumbly at the core. The analogy is apt.
- 1.12 At the surface or macro level, performance from 1978-1982 was impressive both absolutely and relatively. Few countries besides Egypt could boast, over this period, of real GDP growth rates averaging 8-9 percent per annum; of investment averaging in excess or 25 percent of GDP; of consumer price inflation that was held to an average annual rate of about 14 percent; and of unprecedented growth in import capacity deriving from a combination of rapidly growing export earnings, aid-related medium and long term capital flows, and direct foreign investment. Still fewer countries could boast of labor shortages across virtually all skill classes and the counterpart of these shortages abundant and convincing empirical evidence on trends in real income gains from occupational employment that justify the claim that standards of living had risen and that poverty had been reduced.
- The crux of the "sweet on the outside/crumbly on the inside" 1.13 paradox can be stated quite simply. Eqypt's impressive performance depended far less on the efficient allocation of the resources available to Egypt than it depended on the sheer, unprecedented growth of the resources available to Egypt to manage. This growth in resources came from exceptionally buoyant growth rates in earnings from petroleum exports, workers remittances, Suez Canal fees and tourism and, to a lesser extent, from non-Arab aid flows. They permitted Egypt to register impressive gains in macro performance while simultaneously permitting Egypt to postpone structural adjustments, particularly at the level of pricing, that could have positioned Egypt to absorb a flattening in external resource levels without affecting living standards. Illustrative examples of these pricing problems and their magnitude and pervasiveness across all sectors are summarized in tables 5, 6, 7 and 8. In brief, energy prices are less than 20 percent of their international market price equivalents; farmgate prices, through a variety of direct and indirect controls, average 50% of their border price equivalents; food prices are subsidized to the point of making it cheap to feed bread to animals; and infrastructure service prices for water, wastewater and telecommunication are fixed at levels that do not cover either financial or economic O&M costs, let alone provide a basis for contributing to investment requirements for service expansion.
- 1.14 During the transitory period of resource buoyancy, Egypt did not have to be concerned about a price signaling environment that did not send signals for production, investment, consumption and trade that were in accordance with Egypt's comparative advantages. In essence, there were no pressure points from the budget, the balance of payments or from



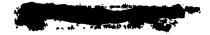


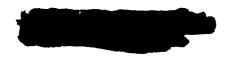
growth trends that said, "you are doing something wrong." On the contrary, growth trends were favorable, and export earnings and budget revenues were in exceptionally good shape precisely because of the directly favorable impact of abundant resources on both.

- The statistical evidence with respect to these directly favorable 1.15 impacts on budget and export revenues tells the story in dramatic terms. Between 1977 and GOE FY 1981/82, budget revenues from petroleum and the Suez Canal in the form of profit transfers alone rose seven fold, from less than LE 200 million to over LE 1,500 million. Total tax and profit transfers from petroleum and the Canal reached over 40 percent of total Government Revenue in FY 81/82, a rise from about 10 percent in 1977. The direct export revenue impact tells an equally striking story. In FY 81/82, over 60 percent of total recorded foreign exchange earnings were derived from petroleum, remittances, the Canal and tourism, \$5.2 billion out of total recorded earnings of \$6.8 billion. Recorded export earnings from these sources were practically nil in 1975. They first rose sharply in 1976, reflecting the favorable coincidence of a number of factors: the re-opening of the canal and return of the Gulf of Suez oil fields in 1975, the continuing net emigration of Egyptian workers to neighboring Arab countries, and the stimulus to western tourism provided by the initiation of the peace effort. A second increase in foreign exchange earnings began in 1979. This second increase primarily reflected the fortuitous coincidence of the "second round" of OPEC price increases with the initiation of oil production from new oil fields and from fields recovered from Israel in 1979.
- The position now is that pressure points reflecting bleaker prospects have arisen. The dramatic rise in resource availability has been replaced by a long term leveling off in resource availability that began in 1981 and 1982. While the world oil market obviously is unpredictable, the balance of opinion points to stable demand through this decade and to a softening in (real) petroleum prices. Suez Canal earnings are constrained by the capacity limits of the Canal itself. The demand for Egyptian workers in neighboring countries probably has peaked. At best, Canal and remittance income will keep up with trends in Egypt's dollar import prices. Tourism, alone, has real growth potential but is hardly sufficient to "drive" the macro aggregates. Exacerbating each of these longer run trends is the short run impact of the world recession on oil demand, on Suez Canal traffic, on tourism and the demand for Egyptian labor abroad. At the same time, however, the decline in prices for important food imports - wheat, sugar and corn - is alleviating the immediate strains.
- 1.17 In essence, Egypt faces a tightened resource constraint and that tightened situation is mirrored in the growth, budget and balance of payments prospects for 1983 and beyond.

2. Growth Prospects

1.18 There is little doubt that Egypt will register a decline in growth in FY 1982/1983. Together, the petroleum, canal and tourism sectors currently account for 25 percent of GDP. At best, these sectors will

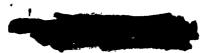




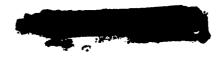
grow modestly in real terms in 1983. Petroleum production volumes are up marginally at best. Suez Canal traffic, due to declining tanker traffic and an overall recession in world trade volume, is flat. Tourism, as measured in volume terms by aggregate tourist "nights" is growing only slightly. As these sectors, particularly petroleum, had been among the fastest growing sectors in the economy, the sharp slow down in their growth is virtually certain to pull down the aggregate growth rate. Quite simply, there is little prospect that growth trends in the other sectors will surpass the already buoyant levels registered prior to 1983. The construction sector is one case in point. In part the high growth rates recorded in this sector have depended on buoyant growth rates in real workers remittances and these remittances have leveled off in real terms.

3. Budget Prospects

- 1.19 As indicated in Annex Table 3, pressure points are being registered in the GOE budget in FY 1982/83. Unlike the almost doubling of revenues that occurred between FY 1979 and FY 1980/81, revenue estimates for the current (FY 1982/83) fiscal year, discounted for inflation, are probably no higher in real terms than actual revenues in FY 1981/82. The leveling off in real terms largely reflects the decline in resource buoyancy from petroleum and the Canal.
- 1.20 Reflecting the leveling off in revenues, the GOE is attempting to hold current expenditures and investment expenditures to levels that will contain the need for "excessive" bank financing. While substantially improved over the magnitude of bank financing required in FY 1981/82, the figures still do not look very promising. In particular, even with budgeted current expenditures only marginally above FY 1981/82 actuals, the budget estimate for current revenues means that the GOE is faced with a negative current savings estimate of LE 133 million. On top of investment expenditures of LE 4.0 billion, marginally below the FY 1981/82 preliminary actual of LE 4.2 billion, this produces a net financing requirement of LE 4.3 billion. Of this amount, LE 1.5 billion, or about 30% of the total, is estimated to come from the banking system. (The figure should not, however, be taken as indicative of strong inflationary pressures of domestic demand on domestic capacity, as a very large component of GOE expenditures are for imported rather than domestically produced goods and services).
- 1.21 From the perspective of USAID strategy, the really important aspects of these developments in the budget are what they suggest about GOE priorities: given buoyant budget revenues the (price) subsidy bill will be expanded rather than addressed, and given a tight budget situation the burden of adjustment will fall more on investment than on subsidies. Both of these conclusions follow directly from the budget table and explain the reluctance of USAID to expand the cash transfer component of USAID assistance. The result would only be further delays and postponements in addressing the pricing and other structural problems that simply have to be addressed and that will be magnified by further delays in addressing them. A second implication for USAID is that doubt





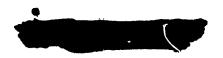


is cast on the GOE's ability to provide the local currency financing component of projects in the investment budget. The constraints on expenditure will be tight and even call into question the ability of the GOE to fund the large local currency requirements of a USAID strategy that focuses on water/wastewater projects.

4. Balance of Payments Prospects

- 1.22 Given the even larger and more direct dependence of the balance of payments on petroleum, the Canal, remittances and tourism, it is hardly surprising that the leveling off in earnings from these sources also has produced a tightening balance of payment situation.
- 1.23 The tightening is directly reflected in Annex Table 9. As indicated in Annex Table 9-C, Egypt's current account balance weakened by slightly over \$ 1 billion between FY 1980/81 and FY 1981/82, with the current account deficit rising from \$ 1.5 billion to slightly over \$ 2.6 billion. Inclusive of amortization obligations on existing debt in each of these years, total foreign exchange financing requirements for FY 1980/81 and FY 1981/82 were, respectively, \$ 3.5 billion and \$6.3 billion. In each year, Egypt was able to meet these large financing requirements without affecting foreign exchange reserves. However, these financing requirements were increasingly met by resort to short-term banking facilities and other short-term loans. Reflecting this, the total debt service ratio rose from 22.1% in FY 1980/81 to 47.9% in FY 1981/82.
- For FY 1982/83, we tentatively are projecting a current account deficit of \$ 2.2 billion, a moderate strengthening from the exceptionally large current account deficit recorded in FY 1981/82. The improvement reflects a number of factors and none of these factors implies a relaxation in the foreign exchange constraint. Foremost among the key factors are substantial but largely temporary international price decreases in the principal foodstuff commodities that Egypts imports, mainly wheat, sugar and corn. The improvement also reflects trends toward lower interest rates on that portion of Egypt's debt that is linked to LIBOR rates and moderately enhanced earnings from petroleum and cotton. With respect to petroleum, the GOE has stepped up production by about 5% as a direct consequence of the need to expand export earnings. With luck the production increase will be sufficient to offset the impact of any further petroleum price decreases on petroleum export earnings. Sales of cotton from a substantial stock carry over from last year's cotton crop are anticipated to increase cotton export earnings in spite of weak international cotton prices.
- 1.25 In spite of the moderate strengthening in the current balance, the tightness in the balance of payments situation is readily apparent. On top of amortization obligations of \$4.3 billion, the \$2.2 billion current account deficit produces a gross financing requirement of \$6.5 billion. Of this amount, direct investment can reasonably be relied upon to provide \$300 million. The balance will have to come from a combination of medium and long term capital inflows and short-term capital inflows.

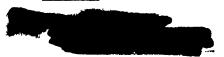


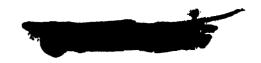


The prospects that the balance can or, more important, prudently can be financed are not good. In fact, based on a careful analysis of the likely capital inflows that Egypt reasonably can rely upon, there is a financing shortfall of some \$ 900 million. Egypt probably will be able to bridge this financing gap through increased short term borrowing. This, however, would not be prudent. Such borrowing would have a quick impact on a debt service ratio that already has reached "watch" list proportions in the international banking community. Thus, the GOE may be under pressure to contain import levels through administrative actions in order to reduce the current account deficit. Obviously, this would be a "pyrrhic victory" sort of improvement in the balance of payments, as it would reduce the imports available for production, investment, and consumption to match the constraint imposed by foreign exchange availabilities, as distinct from an improvement based on relaxing the constraint itself.

5. The Overall Foreign Exchange Situation

- 1.26 The quick review above of recent and prospective developments in the balance of payments situation is less useful as a statement about the overall foreign exchange situation than as a guide to the pressures that the GOE sees itself as facing and as a basis for explaining/analyzing the largely expedient, as distinct from corrective, measures the GOE has undertaken to contain the situation.
- 1.27 The limited usefulness of the balance of payments table as a guide to the overall foreign exchange situation follows from the fact that Egypt has both a private and an official foreign exchange market and the balance of payments table largely is limited to recording developments in the official market. When, however, direct account is taken of the private foreign exchange market, a picture of the overall foreign exchange situation emerges that is not just "more accurate." It lays the basis for explaining how the GOE has been attempting to manage the situation. This in turn lays the basis for explaining the implications of GOE management of the foreign exchange situation from the perspective of USAID.
- 1.28 Taking into direct account the private foreign exchange market does not alter the overall picture drastically. The overall situation can still be described as tight, but the tightness is greater in the official market than it is in the private market. The basis for these observations and the explanation underlying it are set forth in Table 1, Egypt: Indicators of Developments in the Foreign Exchange Market.
- 1.29 The key to the explanation of the differing degrees of tightness lies in the widening gap between the official exchange rates and the private or "own" exchange rate. Because of the widening gap between the private and official rates, workers abroad have become increasingly reluctant to convert their remittances into LE in the official market. Similarly, tourists have increasingly exchanged dollars for LE in the private market rather than the official market. In fact, in the line items in Table 1 representing official earnings from tourism and official





cash remittances, there were actual declines between 1980/81 and 1981/82. The reduction in conversions in the official market is readily explained by the premium of the own exchange rate over the official exchange rate. In neither case can the reduction in conversions in the official market be regarded as a reduction in total remittance and tourism earnings accruing to the Egyptian economy. That this is so is suggested, if not actually "proven", by the line item in Table 1 entitled private claims in foreign currency on Egyptian banks. The increase in these claims, averaging close to \$1 billion per year, represents fairly strong evidence that total remittance and tourism earnings are actually growing in nominal terms, with, however, an increasing proportion of them entering privately held foreign currency balances.

1.30 Two further factors underlying the trend towards reduced conversion of foreign exchange into LE in the official market also are apparent from Text Table 1. First, the interest rate on dollar deposits placed in Egyptian banks has been uniformly above the interest rate on LE denominated deposits for identical maturities. This, of course, represents a further incentive not to convert dollars into LE. Second, as the LE has been depreciating relative to the dollar in the own exchange market, holders of dollar deposits are able to obtain a fairly high "appreciation" related rate of return on dollar denominated assets. Both of these two factors have been mutually self reinforcing reasons for keeping dollars as dollar assets rather than converting them into LE.

6. GOE Policy Responses to the Foreign Exchange Situation

1.31 The really interesting aspects of these developments in the foreign exchange situation are the GOE policy responses, both what the GOE could have done and what the GOE actually has done. Before addressing these responses in a formal sense, it is useful to view the situation from the position of a GOE policy manager faced with a situation in which there are pressing claims on publicly owned foreign exchange balances, losses to the publicly available pool because of price incentive induced leakages to the private sector, and a growing pool of privately held foreign currency balances.

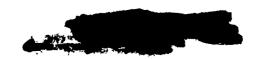
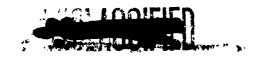




TABLE 1

EGYPT: INDICATORS OF DEVELOPMENTS IN THE FOREIGN EXCHANGE SITUATION (Amounts in Millions of US\$'s Unless Otherwise Indicated)

| | | 1979 | 1980/81 | 1981/82 | 1982/83 |
|---|---------------------------------------|---------------------|---------------------|---------------------|--|
| | | | | | |
| Net New Financing Requirements 1 | | 1100 | 1200 | 2300 | 1800 |
| Refinancing Requirments | | 1788 | 2027 | 3663 | 4288/69883/ |
| Total Financing Requirement of Which Disbursements on Medium & Long Term External Debt4 | | 2888 | 3227 | 5963 | 6088/8788 <u>3</u> / |
| | | 2301 | 2508 | 2934 | 3300 |
| Other Fi | Other Financing2/ | | 719 | 3029 | 2788/5488 ³ / |
| Debt Servi | <u>ce</u> Interest Amortization | 2216 428 1788 | 2280 759 2027 | 4577 914 3663 | 7 <u>988</u> 1000 4288/6988 <u>3</u> / |
| Medium & Long | Interest Amortization | 241 812 | 301 1115 | 404 1357 | 500 1700/2700 <u>3</u> / |
| Other | Interest Amortization | 187 251 | 458 912 | 510 2306 | 500 2588 |
| Exports of Goods, Factor and Non Factor Services | | 7044 | 10340 | 9549 | 10040 |
| Debt Servi Ratios in | | | | | |
| On Medium and Long Term External | | 14.9 | 13.7 | 18.4 | 21.9/54.0 ³ / |
| On Tot | al Debt in F.C. | 31.4 | 22.1 | 47.9 | 52.7/88.83/ |
| Exchange Rates (LE per Dollar) Official Official Incentive "Own" exchange rate5/ | | 0.70 0.74 | 0.70 0.80 | 0.84 | 0.70 0.84 1.18 |
| Premium of own rate in % 1. Relative to official 5.6 14.2 2. Relative to official Inc | | | | 31.4 9.5 | 68.6 40. 5 |



| | <u>1979</u> | 1980/81 | 1981/82 | 1982/83 |
|---|-------------------------|--------------------------|-------------------------|-------------------------|
| | | | | |
| Interest Rates (in %) on LE denominated assets (1 year Maturity)6/ | 7.0 | 9.0/9.5 | 10.0 | 11.0 |
| On \$ denominated assets (1 year Maturity) 5/ | 10.5 | 18.0 | 14.5 | 12.5 |
| Official Tourism Earnings | 601 | 712 | 616 | 700 |
| Official Remittances Cash Own Exchange Imports | 2214 (954) (1260) | 2625 (1066) (1560) | 1741 (660) (1081) | 1800 (700) (1100) |
| Private Claims in Foreign Currency on Egyptian Banks6/ Level Change in Level | 718 250 | 1365 647 | 2357 992 | 3571 1214 |
| Position VIS-A-VIS Egypt Of Banks in BIS Reporting Area 7/ Liabilities to Egyptian | | | | |
| Depositors Claims on Egyptian | 3800 | 5100 | 5566 | 6971 |
| Depositors Net Liabilities to Egypt | 2000 1800 | 3100 2000 | 4434 1132 | 5350 1621 |
| Change in Liabilities Change in Claims Change in Net Liabilities | | 1300 1100 200 | 466 1334 - 868 | 1405 916 489 |
| International Reserves8/ Total Reserves Minus gold Gold in Million Troy OZ | 529 2432 | 1046 2432 | 716 2432 | 734 2432 |
| Total Reserves with gold valued at US \$ 450 0Z | | | | 1828 |

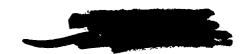
Source: Annex Table 9, Egypt: Balance of Payments, unless otherwise indicated.

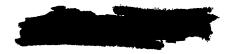
 $\frac{1}{2}$ Current account deficit minus direct foreign investment $\frac{2}{2}$ Includes external debt and domestic debt denominated in foreign currency $\frac{3}{2}$ Includes amortization on GODE debt (\$ 1700 million) and bilateral clearing balances (\$ 1000 million).

4/ Table 10

5/ USAID/Cairo estimates based on various sources 6/ Central Bank of Egypt.
7/ BIS data

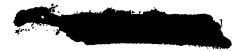
8/ International Monetary Fund, IFS data.





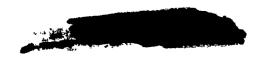
Faced with this situation, the options are fairly clear:

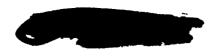
- -- postpone, by borrowing abroad, the need to arrest and reverse the foreign exchange constraint in the official market;
- -- tighten up on the allocation of publicly available foreign exchange in order to ration the amount available among competing public sector claimants;
- -- adopt measures designed to compress the gap between the official and own exchange rates with the objective of making the official market a more attractive alternative to the own exchange market;
- -- reduce the ability of the own exchange market to finance private imports and/or or raise the effective price of these imports in the hopes that more of the flows into the private market will be channeled back into the official market;
- -- failing to achieve much success in rechanneling flows back to the official market, try to borrow, through a variety of direct and indirect means, from the growing pool of privately held foreign currency balances held as deposits in Egyptian banks;
- -- "look the other way" and perhaps even encourage public sector entities to tap the own exchange market indirectly through such devices as permitting them to pay a "fee" equal to the premium of the own exchange rate to banks that offer to act as informal agents between the public entities and private holders of foreign currency balance;
- -- allow public sector companies to give sales order/delivery preferences to buyers who offer to pay dollars instead of LE for goods produced by these companies;
- -- adopt exchange rate and interest rate policies that would enable the official market to complete on more equal "price" terms (exchange rate, interest rate) with the own exchange market for the total available supply of foreign exchange.
- -- attempt to structure the AID program and other sources of aid along cash transfer lines; and
- -- initiate policies that would actually relax the foreign exchange constraint as an alternative to, or from a more realistic point of view, in conjunction with, policies such as borrowing that buy a bit more time or polices that rely on administrative interventions to match existing availabilities to overall claims on these availabilities.
- 1.32 In effect, when the list of options is compared with the fairly large and representative sample of GOE policy responses in Text Table 2, a fairly simple conclusion emerges: The GOE has tried a bit of everything above. It neverthless is clear that the balance of emphasis has not been on market type measures.





- 1.33 Illustrating this, only three of the measures listed in Table 2 can be regarded as market type measures: the establishment of the official incentive rate in August 1981; the upward revision in interest rates on L.E. denominated bank deposits that the Central Bank initiated in 1980 and the authorities' willingness to tolerate the occasional, limited development of a "grey" market devaluation. This grey market devaluation follows from actually allowing public sector firms to buy foreign exchange at the own exchange rate through enabling them to pay a fee equal to the premium on the own exchange rate to banks that act as agents between the companies and private holders of foreign currency deposits. While none of these measures had a major impact in channeling flows back to the official market each could have had a much larger effect.
- 1.34 A good illustration of this point is the limited "market type" measures the GOE took in the exchange rate/interest rate area. In principle, the creation of the official incentive rate at LE 0.84 = US \$1.00 was a potentially effective approach to making the official market a more attractive alternative to the own exchange market. In practice, it did not have a major impact because the rate did not really meet the competition from the own exchange market even at the time it was established and, because it has not been changed, it has become increasingly "homeopathic" relative to the dose that would now be required to make it effective. The same sort of conclusion applies to GOE steps on the interest rate positive, but in a dose insufficient to effect a cure. In essence, in order to have been effective, GOE moves on exchange rates and interest rates needed to meet and continue to meet the competition from the own exchange market; they did not.
- 1.35 Some examples of the GOE's emphasis to date on non-market measures deserves special mention because they are potentially dangerous and because they illustrate some of the trade-offs that have faced the GOE in its attempts to ameliorate the foreign exchange constraint in the official market. Again, place yourself in the shoes of an Egyptian policymaker. From the perspective of GOE policymakers, external borrowing is an option that has some pretty severe consequences. In brief, such borrowing is public knowledge. It becomes incorporated in external debt statistics. Growth in external borrowing, especially non-project related, short-term borrowing, affects Egypt's credit worthiness. This, in turn reduces the availability of future external credit and simultaneously raises the spread over LIBOR that Egypt would have to accept.
- 1.36 Given this set of circumstances surrounding the external borrowing option, it is fairly clear why Egypt, when it did not achieve much success in making the official market a more attractive alternative to the own exchange market, more or less "fell" into the option of borrowing foreign exchange from internal sources. There are a lot of advantages. It doesn't show up in the public record or in the balance of payments statistics (because it is a transaction between "residents"). It can oftentimes be done "cheaply" and may mesh well with other objectives.





- 1.37 The advantages of the internal option are well illustrated by the reserve requirement that the GOE instituted on foreign currency deposits and by the prior import deposit scheme. In effect, the 15% reserve requirement has provided the GOE, through the Central Bank, with a "loan" of almost \$ 400 million in foreign currency. The cost to the GOE is cheap at LIBOR. Moreover, it is a permanent loan so long as the foreign exchange deposits remain in the banking system. Similarly, the prior import deposit scheme has provided the GOE, through the Central Bank, with a self renewing "loan" in foreign currency of some \$300 million at current levels of own exchange imports.
- 1.38 The "danger" associated with these forms of loans is that the GOE probably has used the foreign exchange to meet the demands in the official sector, acquiring an LE denominated claim against the public sector entity that received the dollars. To the extent that this is the case and it is probably true the banking system has acquired an "exposed" position in foreign exchange i.e., one which is not covered by an equivalent foreign exchange asset, let alone one that matches the underlying maturity structure of its foreign exchange liabilities. More pointedly, if depositors try to shift their foreign currency deposits out of Egypt, it could pose some difficulties for the banking system. There is no point, however, in being alarmist about the situation. After all the Central Bank does have foreign exchange reserves. Nevertheless, any bank examiner in the U.S., seeing this sort of situation developing, would raise it as a "cause celebre."
- 1.39 On this same point, there is some evidence that an even more dangerous situation could develop. By setting up the "import account" system and restricting licenses allowing those accounts to be actually used to finance imports, the Central Bank may in effect be sequestering these deposits so that the foreign exchange can be used to feed the official market through tapping the private market in a distinctly "unbankmanlike" way. There is, in fact, some evidence that this sterilization is taking place to at least a minor degree. First, the fall in own exchange imports, recorded in Table 9, is only partly due to the import price increasing effects of the luxury consumption tax, the prior import deposit scheme, and the like. It is also due to tightening up on licensing. These factors, in combination with the establishment of the import deposit accounts, has provided the pool that is available for tapping. All it then takes is using the pool and the incentive for that is clearly there.
 - 7. USAID's Strategic Imperatives, the Foreign Exchange Shortfall and the Political Economy of Egypt
- 1.40 From the perspective of USAID strategy formulation, the major questions have not yet even been posed. Simply put these questions are: why has the GOE been so slow in adopting policies that would correct the overall foreign exchange/resource availability constraint and what are the chances that the GOE will, and the consequences if the GOE does not, introduced.



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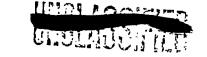
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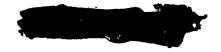
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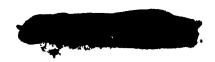
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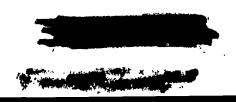
- 1.41 For the most part, the answer to the first question was set forth in detail in the FY 1984 CDSS annex, "Policy Issues Facing Egypt". In brief, the more than generation-long Nasser period left Egypt with a difficult legacy to overcome. The foundations of that legacy were:
 - -- an orientation towards economic development that was based on autarky/import substitution as a basis for production and investment decisions;
 - -- the use of direct public sector ownership in the commodity producing sectors to achieve commodity output objectives.
 - -- the use of the pricing system to achieve welfare and production objectives in a manner that left the pricing system massively out of synchronization with economic reality.
- 1.42 The legacy this orientation created can be summarized simply:
 - -- a structure of relative prices facing the agricultural, industrial and household sectors that does not signal at all well what to produce, consume, import or export and where to invest in terms of real economic costs and, far more important.
 - -- a capital stock, a structure of production in the agricultural and industrial sectors, and a system of price-based welfare/income payments to households that have made maintenance the status quo -- in pricing and everything else associated with it -- a self-fulfilling argument for preserving the current set of policies.
- 1.43 The last point deserves special emphasis because it underscores the difficulties Egyptian policy makers perceive in making precisely the kind of policy adjustments that USAID, among others, has urge? the GOE to make.
- 1.44 From the Egyptian perspective, raising subsidized prices is fraught with political problems. Energy prices are one case in point. Egypt's industrial structure today has been built up, over a twenty year period, on the basis of energy prices that are now less than 1/5 their international market price equivalents. In many industries, energy costs of production amount to greater than 10% of total and unit production costs. A five-fold increase in energy prices, therefore, would raise unit production costs by some 50%. If these cost increases then were passed on into final product prices, the result would be a 50% increase in prices.
- 1.45 To take a broader example that is specific to the household level, food and energy price subsidies combined provide the average household in Egypt with an income equivalent that is equal to 40% of average household income (based on 1979 data). That is, it would taken an income transfer equal to 40% of average household to buy the same basket of goods as before, except at unsubsidized prices.

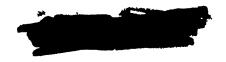


- 1.46 These types of examples can be extended ad infinitum, but the two examples are enough to call the story. No government ever made itself popular by raising prices. Egypt's nascent democratic institutions are not so mature, nor its experience with the practice of democracy so advanced, as to offer citizens complete redress (via the ballot-box) against unpopular governmental actions and policies. While President Mubarak has gone to great lengths to "educate" Egypt's body-politic about the immensity of the country's economic problems and the need for greater public discipline and economic reforms, the prospect of mass protest demonstrations and violent civil unrest in response to government reform initiatives is never far from official consciousness. This helps to explain and also lend credence to the stance of the Egyptian Government that reform must be "gradual".
- 1.47 The primary issue facing the GOE is the "speed of movement". What speed is economically desirable? what speed is politically possible? and are either of these "speeds" compatible with the time Egypt has left to make the required adjustments. If Egypt does not make the reforms, there will simply be declining living standards as Egypt tries to divide up a probably diminishing pie among competing claimaints. Even if Egypt does initiate the reform process, there will be plenty of short run adjustment problems that are bound to impose costs on different parts of the economy.
- 1.48 Prospects for reform at this stage are highly uncertain. The tightening in the foreign exchange situation is pulling in two opposing directions at once. On the one hand, the tightening is elevating the reform option to the attention of government. On the other hand, the tightening also is resulting in pressures in favor of strengthening centralized control over the allocation of resources. As noted above, AID itself is under pressure to alleviate the tightening through providing foreign exchange resources that can be freely allocated by government. These pressures do need to be resisted, not in a confrontational manner, but through seeking mutual agreement on areas of concentration that merit attention on developmental grounds. Health, education, water, sewerage and other areas of social infrastructure do represent areas of potential agreement on developmental grounds. These emphases, however, should not preclude opportunities for support in the commodity producing sectors where traditional cost/benefit analyses suggest that there are worthwhile opportunities.

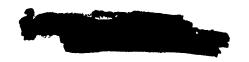
8. Egypt's Development Constraints in the Economic Policy Sphere

1.49 If there is one single message that emerges from the foregoing, it is this: a substantial share of Egypt's primary development constraints are constraints that reflect a deeply embedded legacy of economic policy mismanagement and, equally, the constraints imposed by the economically severe and potentially disruptive problems that would be associated with changing the course of policy.

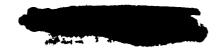




- It also should be emphasized that some of the economic policy management-related constraints to Egypt's development are not easy to address with the simple expedient of resource transfers. One case in point is stimulating increased private investment and production in the commodity producing agricultural and industrial sectors. Investment in these areas is characterized by large up front expenditures, an oftentimes long gestation period before full production is reached, and an even longer period over which the investor will realize the returns from investment. Given Egypt's policy history of nationalizations, of price controls on output, of subsidized competition from public sector production and a host of other risk-elevating factors, the private sector quite legitimately is reluctant to commit funds for investment in commodity production activities. Problems such as these are only indirectly addressable through resource transfers. The more appropriate forum is policy dialoque and the results of that dialoque clearly depend on mutual complementarity between AID resources and Government policy.
- The economic policy constraints were discussed at some length in 1.51 the Mission's "Policy Issues" Annex to last year's CDSS. A fundamentally dysfunctional set of policies serves to maintain a price structure that gives signals to agricultural and industrial producers, to household consumers, and to investors that are inconsistent with Egypt's comparative advantages. Legitimate concern with the welfare of the urban population has led to an all-pervasive system of subsidies that is becoming increasingly unmanageable From the point of view of resource availability. Virtually all aspects of the system of economic management are designed to keep prices low. Illustrating this, "supply commodity" imports are valued at the official exchange rate of LE 0.70 per dollar (rather than at the official incentive commercial bank rate of LE 0.84 per dollar) in order to keep consumer prices low. In agriculture, price policy serves to transfer income out of the agricultural sector to help support the politically more volatile urban areas: domestic procurement prices for agricultural commodities range between 25 per cent and 80 per cent of international prices. In industry, public sector firms are assigned production quotas of low quality "popular" goods for which low output prices are fixed by the GOE; public sector producers often are obliged to run losses that then are covered in the national budget. most striking price distortions relate to energy products (petroleum products and electricity). The GOE has not passed on to energy users the OPEC-induced energy price increases of the last decade, with the result that energy prices in Egypt are less than one-fifth of the international price even when converted to LE at the low official exchange rate.
- 1.52 The second major policy-generated constraint is the set of limitations on private sector industrial activity inherited from the Nasser period. The explicit limitations include: the licensing system for new investments, which serves in part to protect the vested interest and the competitive position of existing public sector firms; and preferential access to foreign exchange, credit and raw materials for public sector firms which discriminates against the private sector. Implicit limitations, that shorten the time horizon of private investors







are (a) considerable doubt as to the constancy of government policy and (b) concern over an eventual threat of future nationalizations were the political winds again to shift in the direction of the Nasser precedent.

C. DEVELOPMENT STATUS AND NON-ECONOMIC CONSTRAINTS

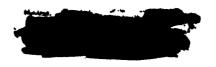
1. Resource-based Constraints

1.53 It should be emphasized that there certainly are constraints to Egypt's development that are very indirectly or, perhaps, not at all related to economic policy management. Essentially, these are resource-based constraints. Indicators of these constraints are characteristic of the Third World: poverty; underemployment; lagging agricultural and industrial development; and rapid urbanization. They, however, are dominated by a combination of features peculiar to Egypt: a rapidly increasing population (2.6 - 2.8 percent per year); a limited supply of cultivable land, sharply defined primarily by the course of the Nile and the size of its Delta; and a bureaucratic tradition dating back perhaps 5,000 years. The simple fact is that, as analyzed in greater detail below, Egypt is a poor country with limited investment resources leftover after minimum consumption needs are met:

a. Poverty

- 1.54 Egypt, with a per capita GDP of about \$543 in 1981/82, ranks low in the array of middle income countries as defined by the World Bank. With 20 percent of the gross domestic product originating in agriculture and only 14 percent originating in manufacturing, the country exhibits many of the standard characteristics of economic underdevelopment and poverty. Despite several years of rapid economic growth in the late 1970's and a continued high level of activity in sectors such as construction, the country suffers from a number of economic ills: low productivity; a rather high degree of income inequality (a Gini coefficient of 0.38 in the mid-1970's); inadequate and, in many spheres, deteriorating social services.
- Poverty in Egypt is both rural and urban. In rural areas some 35 percent of households were estimated to have incomes below a poverty line of LE 327 in 1977, the most recent year for which data are available. In that year, only 50 percent of the income of rural households was derived from agriculture, close to 35 percent was derived from non-farm wages (earned mostly outside the villages), 10 percent was derived from non-agricultural assets, and 5 percent from remittances. Most rural households derive income from several sources. The poorest 20 percent were single member households, the old and the disabled, and those trapped in low productivity non-farm rural activities. The second lowest 20 percent were families engaged predominantly in agricultural labor, although agricultural wages rose in real terms in the mid-1970's. Since then, much of the excess of agricultural labor has drifted off to the cities or emigrated to the other countries in the region. Higher incomes are associated with access to land, the poorest in the land-holding category being sub-marginal farmers with less than 5 feddans. Small



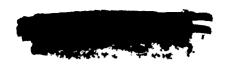


holdings act as a trap for family labor, where male workers are underemployed because they are locked into working sub-marginal holdings. Women in rural households are, on the contrary, overworked, but they do have the production of livestock as a separate source of income throughout the year.

1.56 The urban working poor include many of those in low productivity activities in the informal sector, as well as the lower paid echelons of the formal private and public sectors. Unskilled workers in small-scale manufacturing, often women and teenage apprentices, are among the lowest paid groups in the formal sector. Although female participation in the industrial work force is a well established tradition in urban areas, the labor force participation rate for uneducated women fell between 1960 and 1976, according to the results of the population censuses of those two years. The responsibility of women as family income earners in urban areas, on the contrary, probably has increased during the same period.

b. Employment and Human Resources

- The current employment situation in Egypt is one of little open unemployment. This, however, is a deceptive indicator. The government traditionally has acted as an employer of last resort (and, at times, first resort), with the result that there is a massive degree of underemployment in government jobs created to prevent open unemployment. Overlaid on massive underemployment in the public sector are relative shortages of workers (particularly skilled workers) at going wage rates in agriculture, industry, and construction. In large part, this reflects emigration of male workers to the Gulf states and elsewhere. In agriculture, the worst-off group of workers, the traheel, a class of migrant agricultural laborers who followed the crops up and down the Nile Valley, largely have disappeared during the past decade. They now are working in urban construction jobs in Egypt, as fellahin in Sudan, Iraq and Jordan, and - as thousands of other Egyptians - in all kinds of jobs in the oil-rich Gulf states. Agricultural wages in Egypt have risen in response to shortages of landless laborers for hire and are comparable with wage rates for unskilled workers in industry, who earn the lowest wages in urban areas. Earnings of the self-employed and others in the micro-enterprises making up the urban informal sector are comparable with (and in many cases higher than) wages of unskilled workers in industry.
- 1.58 Employment of women outside the home in urban Egypt has been affected by opposing forces over the last decade. By the mid-1970s, lack of educational credentials was beginning to act as an obstacle to access to regular employment in the formal sector for uneducated women, although the small minority of women who received higher education were breaking into new areas of employment. More recently the emigration of male workers has encouraged the growth of employment opportunities for women in industry.
- 1.59 Shortages of skilled labor in urban areas are a negative short-run side effect of emigration. Perhaps more important is the longer run threat of unemployment if and when the migrants are obliged to return or

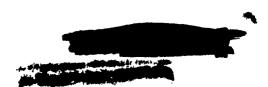


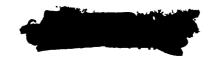
when the opportunities for further emigration dry up. The post-1975 economic boom in Egypt and the temporary palliative of emigration have postponed Egypt's employment crisis. New entrants to the labor force over the next decade and a half will be considerably more numerous than the Egyptian economy can absorb without a rapid expansion in employment opportunities in industry and productive services. Such an expansion does not seem likely to occur unless a variety of steps are taken in the meanwhile to accelerate industrial growth and to improve the education, training and health conditions of the labor force.

c. Agricultural Growth

- 1.60 Agricultural output per acre in Egypt compares very favorably with average output per acre in the rest of the world. It compares considerably less favorably, however, with output per acre in those countries and areas with a similarly rich natural resource endowment: ideal climatic conditions, rich soil and a developed irrigation infrastructure. These observations apply, however, to the approximately 6 million acres under cultivation. Outside of the Nile basin itself, Egypt is a desert, with very limited opportunities for land reclamation that meet standard cost/benefit criteria. The GOE, however, continues to endorse at least formally, a program of large scale land reclamation as a key element in its overall food security program.
- 1.61 In addition to the limited area suitable for cultivation, agricultural production suffers from technological lags, and from a policy environment that cumulates economic disincentives to production. Even control of the Nile's floods has brought with it some negative side effects: diminishing natural fertility of the soil because silt is contained behind the High Dam instead of flooding the down-river fields; progressive encroachment of the desert on cultivable areas along with increased salinity on the fringes of the valley and in the Delta; and the accelerated spread of water-borne diseases among the agricultural population.
- 1.62 The supply of existing agricultural land is further diminished by the spread of the cities (and other urban amenities such as roads) onto cultivable land in the Cairo area and in the Delta. As indicated above, reclamation of desert areas for agricultural purposes is both costly and, in many cases, not economic at current input and output prices.

 Moreover, the effectiveness of land reclamation requires a higher degree of managerial efficiency than Egyptian institutions usually exhibit.
- 1.63 With the total population growing as fast as, or faster than, food production, the country faces increasing dependence on food imports, for which it can pay only if it increases exports, including exports of high value agricultural goods. If agricultural labor remains in relatively short supply, either because emigration to other countries continues or because of continued drift of the rural population into Egypt's urban labor force, increases in agricultural production will require further mechanization and rapid technical advances.





d. Urbanization

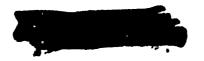
- 1.64 Egypt's urban population has grown rapidly since the 1950s as a result both of high rates of rural to urban migration and of natical increase of the expanding urban population itself. The urban population explosion has created a greatly increased need for urban infrastructure and urban services in old and new urban areas. In the old urban areas, the infrastructure inherited from the pre-1952 era has deteriorated severely during more than two decades of neglected maintenance and has been overwhelmed by the population increase in the areas served as they have become much more densely populated. In new urban areas, many of which are "illegal," urban infrastructure and urban services have been lacking altogether and will have to be provided.
- 1.65 Physical redirection of urban expansion is urgently needed to prevent continued encroachment on limited agricultural land in the Nile Valley and in the Delta. In the Cairo area and to the south, this means that the direction of further development should be changed from its current north-south axis along the river; it should be reoriented along east-west axes into the desert. In the Delta, it implies vertical expansion and greater density in existing urban places. The GOE can affect the direction of new urban expansion by the infrastructure it creates, and by the regulations it imposes and implements.
- 1.66 In view of the limits on the expansion of agriculture, the proportion of the total population living in urban areas will continue to grow, and with it the urban labor force. Egypt will have to cope with two aspects of the urban crisis: the physical problems of providing infrastructure and services, and the creation of productive employment opportunities.

2. Other Constraints

1.67 In addition to the foregoing resource-based constraints, there are institutional, technological, and social constraints that hinder Egypt's development. These are discussed briefly below:

a. Institutional Constraints

1.68 A few of the institutions responsible for Egypt's development work properly, the Suez Canal Authority and the Egyptian National Electricity Company being prime examples. Many of the others—ministries, universities, public sector enterprises, local authorities—are poorly organized, overstaffed wih underpaid and disinterested personnel, and ineffective. The Ministry of Health sometimes seems more concerned with constructing new buildings than with delivering health services; funding for basic educational activities of the Ministry of Education is inadequate; the universities are overwhelmed by thousands of badly prepared students pulled in by the incentive of guaranteed government employment after graduation. Nevertheless, some institutional directors are eager to obtain better training for their personnel, and to see their institutions develop



b. Technological Constraints

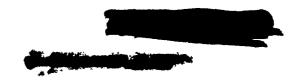
1.69 Technological lags are important in a number of areas. Local construction companies are deemed unable to cope with the technical requirements of installing high pressure sewers in the Canal cities where the water table is high. In some cases, as in agriculture, it is difficult to separate out the effects of input and output price distortions on incentives to use more sophisticated inputs from technical incapacity to use the latter.

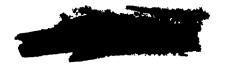
c. Social Constraints

1.70 Certain social attitudes and basic patterns of social behavior may also operate as constraints on development. In particular some aspects of Islam — notably a fatalistic attitude towards one's lot in life — are commonly regarded as constraints to development. Another is traditional attitudes with respect to manual labor by the professional/technical class. Tradition dictates that "hands on" experience is beneath certain educational or status levels, with a probable loss to development potential.

D. KEY VARIABLES

- 1.71 As reflected in the discussion above, the key variables affecting Egypt's development prospects are a complex mix of Egyptian economic policies themselves, a host of natural resources/social constraints that narrow development alternatives, and, equally, a host of natural resource advantages that are largely underexploited. From a more operational perspective, the key long-term issue is population growth. The key immediate to mid-term issues are pricing and regulatory reforms at the agricultural, industrial and household levels. The immediate problem is the balance of payments and foreign exchange constraint.
- 1.72 It is easy to program resources against the surface manifestations of Egypt's development problems, the country's deteriorated capital stock. It is quite another matter to accompany the resource transfer with solutions to the policy issues that have created the need for the resource transfer itself.

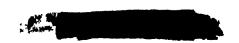




II. PROGRAM STRATEGY AND AREAS OF PROGRAM CONCENTRATION

A. INTRODUCTION

- 2.01 The key strategic implications for U.S. economic strategy in Egypt that emerge from the foregoing are worth summarizing briefly.
- 2.02 On the political side, we indicated that the Mubarak Government has yet to achieve a consensus-based mandate for policy adjustments that would arrest and reverse the foreign exchange constraint. The key components of that policy mandate would include:
 - exchange rate/interest rate adjustments, particularly the former because of the favorable <u>immediate</u> impact that exchange rate adjustment would have on foreign exchange inflows into the official market as well as because of a favourable longer term impact on commodity trade-based foreign exchange flows;
 - -- adjustments in the cost/price structure that would signal properly production and investment decisions that are in conformity with Egypt's comparative advantages over the midand longer-term.
 - -- reforms in the public/private regulatory environment that would effectively unwind a complex mix of administrative regulations that increasingly serve neither efficiency or equity considerations.
- 2.03 To date, there has been little movement, although much discussion, in each of the above areas. The "revealed preference" of the Mubarak Government has been to postpone adjustment, to maintain a kind of status quo through such measures as borrowing foreign resources to meet the resource demands on the economy that flow from the current set of policies. In various forms, AID has been urged to respond to the tightened resource constraint through converting major chunks of AID resources into a cash transfer. The empirical evidence to date suggests that this would retard rather than promote reform. In particular, on the basis of a policy status quo, Egypt easily could enter the "crisis management" class of countries within the next two years. The objective of political stability would be ill-served by an AID program that magnifies rather than reduces the adjustment burden that Egypt faces.
- 2.04 The existing state of affairs in Egypt, along with a host of practical and AID specific considerations, provide a basis for devising an effective, but by no means ideal, strategy. First, AID for political reasons, has an exceptionally large program in Egypt. It is, however, small relative to Egypt's GNP. As such, the contribution that AID can make to Egypt's development is critically dependent upon influencing GOE policies and policymakers. In spite of this implicit limit on our influence, Egypt's economic performance is popularly associated with what



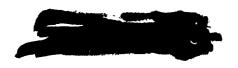


has become known as the "special relationship with the US." Given the high risk that Egypt will experience a downturn in performance, it will be important for AID to reduce the risks that the downturn would reflect unfavorably on the U.S. relationship.

B. STRATEGY

- 2.05 From the outset, we must recognize that the Egypt of 1983 is not the Egypt of ten years ago. The second decade of the U.S.-Egyptian relationship cannot be the same as it was in the first decade and the future AID program must reflect this fact.
- 2.06 At the same time, we must be sensitive to increasing domestic pressure in the U.S., to reduce the level of foreign assistance programs. This factor is relevant to Egypt in the sense that both countries agree it is in each others long-term interests to plan for an eventual reduction in United States assistance. Although it would be premature, both politically and economically to predict when a reduction can begin, U.S. assistance already is decreasing in relative terms as A.I.D. levels remain constant while the overall size of the Egyptian economy continues to grow.
- 2.07 In the foregoing context, we have fashioned a USAID program for the next few years (to 1988) that (a) fits within the general Egyptian Five-Year Plan (1982/83 1986/87) framework, which stresses production, efficiency based productivity gains, basic human needs; (b) attempts to meet the expressed Egyptian highest priority within that framework, improvements in the water and wastewater systems; and (c) avoids, to the extent possible, investment in sectors where our funding merely would serve to accentuate or prolong present policy-induced distortions in the economy.
- 2.08 In essence, we will be concentrating on relatively policy-neutral areas of the economy, laying a foundation for potential sustained economic growth. Aside from water and sewerage, these policy-neutral areas probably will include health, education, population, and science and technology. These latter areas are important not only from a basic human needs (BHN) standpoint but also on productivity grounds in that the provision of skills-training, equipment, and technology transfer will help the Egyptian to identify, prioritize, and solve their development problems effectively and efficiently. These emphases, however, will not preclude our selective support in the sectors of industry and agriculture where traditional cost/benefit analyses suggest that there are worthwhile opportunities. In addition, through the CIP and P.L. 480 programs, we will be providing balance of payments support to assist Egypt to meet its immediate economically-related political concerns. Both of these programs will be used, to the extent possible, to augment Egyptian investment in agriculture and industry, and both will be used, to the maximum possible extent, as instruments of our policy reform dialogue.
- 2.09 In fact, to attain an optimal development impact, the policy dialogue with the GOE will be sustained and enhanced by using the full range of U.S. contacts and program instruments. However, it must be





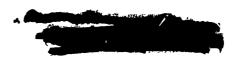
emphasized that the development of Egypt is an Egyptian problem both in terms of its direction and its finance. Reflecting this gross disbursements on foreign aid only amount to eight percent of Egypt's GNP. Three-quarters of this is provided by AID. As stated previously, while eight percent is high by international standards, it is small relative to the other 92 percent of the resources that are the direct management concern of Egyptian policymakers. This has two implications. First, influencing the six or eight percent alone is not sufficient in the face of a seriously policy distorted economy. Second, influence on the management of the 92 percent portion will be critically dependent upon the effectiveness with which we can affect Egyptian policies and policymakers in a framework of partnership and collegiality rather than confrontation. (See Cairo 25772 (82) and Cairo 25760 (82) on Policy Dialogue.)

- 2.10 It should be recognized that between the limitations inherent in any bilateral relationship and the special limitations arising from the U.S. Egypt relationship, our possible impact on macro-level GOE policies is severely constrained. We probably will not decrease aid substantially in the absence of reform nor are we likely to increase aid as a reward for reform. Further, U.S. assistance probably is too small in toto—i.e., even if all of our assistance were converted to direct balance of payments support aid to finance major structural reforms of the entire economy.
- 2.11 In summary, our strategy to 1988 calls for continuing present ESF assistance levels, primarily for political/strategic reasons, but allows for a gradual decrease in P.L. 480 Title I, should circumstances permit. We shall attempt to conduct the assistance program in such a way that we meet as many GOE/USG expectations and interests as possible. We will try to be "flexible," to be quick disbursing and to match GOE priorities. At the same time, we shall attempt to formulate an assistance program within the above context that is developmentally sound, a program that establishes a firm base on which Egypt itself can build over time to become self-supporting and self-sustaining.

C. AREAS OF PROGRAM CONCENTRATION

1. Infrastructure

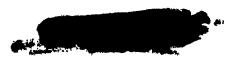
2.12 USAID believes that a program that concentrates on selectively chosen infrastructure interventions is a developmentally and socially sound way to avert the risk that an economic downturn will have an adverse effect on our political relationship with Egypt. Water and sewerage is a case in point. There are a large number of interventions in this area that do make reasonable economic sense on the basis of standard cost/benefit analysis. A major program in this area also would provide a tangible, physically visible contribution to Egypt's development. The U.S. could point, over the near and medium term, to such a program as a highly positive association of the U.S. presence in Egypt. Such a program, by also directly conforming with a major priority





in the GOE Five Year Plan, would meet Egyptian objectives for an AID program that is responsive to GOE priorities. As such, GOE interest in a cash transfer could be deflected, by mutual agreement, into areas where there is close convergence between U.S. concerns and GOE priorities.

- 2.13 Nevertheless, the objective of a selective infrastructure concentration strategy is not simply to "throw" resources at an investment deficit that largely reflects a history of policy mismanagement. In particular, it will be an essential component of USAID strategy to accompany the physical resource transfer with policy changes that will prevent recurrence of the problem itself. Again, the water/sewer area is a case in point. As pointed out earlier, user fees in this area do not even cover O+M costs at either financial or economic prices, let alone provide a basis for financing investment requirements for service expansion. Wage structures in the water/sewer authorities are inadequate to attract, let alone retain, critically needed personnel. This is especially true at the higher engineering and management levels. Both of these policy-related problems derive from Government policy. Both need to be addressed within the context of the programming process at the earliest possible stage. It should be noted that this financial lack of independence from the Central Government budget and wage structures is typical of the whole infrastructure area, rather than being specific to water/sewer.
- 2.14 USAID does plan to address these policy issues. A variety of options will be explored with the GOE. These will include attempting to obtain GOE agreement to set up, either on an overall basis or on a "demonstration" basis, independent water/sewer authorities. That independence could include the right to establish wage structures that conform to requirements for attracting and retaining qualified staff; the right to establish user charges that contribute to, if not fully cover O and M and investment expansion costs; the right to float revenue bonds; and, last but not exhaustively, the right of neighborhoods not served by existing infrastructure to negotiate user fee arrangements for new service that are explicitly recognized as adjustable rather than fixed.
- 2.15 Our initial negotiation with the GOE in the water/wastewater area and in other potential candidate areas for an infrastructure emphasis are at a very early stage. As such, it is far too early to predict the success that we are likely to achieve in resolving the policy issues that are fairly common across all as candidates for infrastructure intervention by USAID. In fact, it should be emphasized that the ultimate infrastructural choices will rest on a blend of practical, managerial, financial and economic considerations.
- 2.16 Clearly, for example, different infrastructure areas have correspondingly different foreign exchange components for an identical investment size. From USAID's perspective, the USAID management difficulties may be independent of the relative size of the foreign exchange component; yet, that is the component AID ordinarily can finance. As another example, USAID's experience with the various infrastructure service authorities clearly suggests that some are far

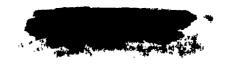




better equipped for project management than others. The Egyptian Electricity Authority and Suez Canal authority are two institutions that have the demonstrated capacity to accomplish a job fairly well. This is not true of our experience to date with the authorities in the water/wastewater area. Unfortunately, from the perspective of the pricing issue, additional electricity generating capacity may be precluded until there are reasonable prospects of appropriate movement on the whole issue of energy prices. Last but not least, the complexities of managing and implementing major infrastructural interventions are demanding and require top-flight USAID managerial capabilities.

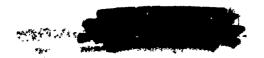
2. Industry and Agriculture

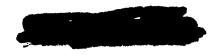
- 2.17 Government policies in Industry and Agriculture preclude, at this time, the relatively large size and mode of programs that would conform to Egypt's heavily under-exploited comparative advantages in these sectors. Nevertheless, in the absence of programs of appropriate size in these areas, USAID would lose major opportunities: opportunities to promote private sector participation in the economy; opportunities to support and encourage GOE initiatives that would relax inefficiencies in the pricing, regulatory and investment regimes; opportunities to support GOE priorities in those areas that do merit support on economic grounds; and, equally, opportunities to expand programs in such areas as policy developments warrant.
- 2.18 On these grounds, USAID does plan to maintain a significant "presence" in the agricultural and industrial areas. In agriculture, our attention will be focused on developing and applying, at the farm level, technologies and agronomic practices that could efficiently raise yields per feddan across a range of commodities. Our policy dialogue relations with the Ministry of Agriculture are good. Reflecting this, we plan to continue working with the Ministry on rationalizing the level and relative structure of farm gate prices, taking into explicit account GOE concerns about the implications of a price rationalization program on the budget, consumer prices, yields and the balance of payments. Our work in this area will continue to focus on how AID resources can be positioned in direct support of financing the intermediate and investment inputs that would be required as a result of a phased price rationalization program.
- 2.19 In industry, our efforts will be directed towards stimulating private sector investment in commodity production, a high GOE priority and a major necessity if Egypt is to develop the export earning supplements that would relax the foreign exchange constraint as well as provide a share of the employment opportunities that Egypt needs to create to offset labor force growth. Under current circumstances, it will not be easy for USAID to structure effective and economically efficient programs in industry. This is, of course, partly due to the very high risk premium that private sector investors quite legitimately require as a basis for committing funds for investment. After all, the returns from such investment will only occur over a relatively long-term horizon, and must be made in the face of a recent history of Government



policies that have been perverse from the perspective of the private sector. Programming in industry also is made difficult because of the existing price structure in Egypt. In particular, if USAID uses financial intermediaries alone to channel funds to the private sector, it will be financial prices and financial considerations that drive both "borrower" and "lender" decisions. Those decisions easily could turn out to be quite wrong from on economic point of view - after all anything can be made profitable to produce with sufficient protection at the border, subsidization of input prices, and the like. For this reason, USAID will be attempting to devise programs that reduce the risks that the private sector itself will become dependent for survival on a price structure that is economically inefficient and that USAID, itself, is trying to change.

- 2.20 With further respect to the industrial sector, USAID believes that attempts to limit access to AID support only to the private sector will be self-defeating. We would exacerbate rather than reduce the tensions that already exist between the public and private sectors. In essence, it will be important to be seen as even-handed with respect to both sectors.
- 2.21 For this reason we will attempt to devise terms of access that "require" and even stimulate a more "market forces" oriented public sector. For example, if the terms of access are based on "market" exchange rates, market interest rates and the like, the result could be a "weaning" of the public sector away from its protected, subsidized status.
- In view of the observations above, USAID industrial strategy will simply have to reflect practical compromises between what is desirable and what is possible. There is, for example, an immense gap between where prices are and where they should be. There is an equally large gap between the regulatory and institutional environments affecting the public and private sectors. Reducing these gaps will not happen overnight. We will simply have to accept far more gradual movement than we would like to accept. We will, for example, simply have to put up with some continuing inequities in the public/private regulatory environment in order to allocate some of our resources in favor of the private sector. We may have to move funds through on-lending facilities and accept the fact, on an interim basis, that financial rather than "economic" prices in commodity markets are driving borrowing decisions. In essence, we have to operate in a second-best situation and be shaped by the environment at the same time as we are trying to reshape it. (Also see Annex B.)
 - 3. Programs in Other Project/Sector Areas Basic Human Needs (Health, Education, Population, etc.), Training, Decentralization, Science and Technology
- 2.23 As noted earlier, there are many areas where relatively small expenditures of AID dollars, even though acompanied by large USAID managerial requirements, make a great deal of sense from a development perspective. While such programs are not absorbers of large program





funds, USAID will plan programs in these areas because of their potential for relaxing important development constraints. Basic Human Needs, Decentralization, Science and Technology, and a variety of Training programs are cases in point. The program rationale in these areas is noted briefly below.

a. Basic Human Needs

Egypt's population problem has to be seen to be believed. Even seeing isn't adequate: On the basis of the percentage of the population that is now below the family formation age, Egypt's population would stabilize at close to 100 million in twenty-years -- even if each new family were only to have two children. The implications of population growth for public infrastructure investment requirements, for job creation necessities, and for everything else are simply mind boggling. Aside from a direct family planning approach to a population strategy, the USAID intends to optimize the impact on population growth of its programs in such sectors as health and education. In addition, health and education programs will be pursued based on their intrinsic merits. We accept the concept that improved health is a necessary condition for increased labor productivity and increased educational attainment. We also accept the maxim that improvements in a country's human capital, especially through the vehicle of community-based basic education, are a key contribution to its economic and social development.

b. Decentralization

2.25 One of the most perverse features of current Government policy is the extent of centralization of government authority in the area of taxes and expenditures. Local Government units have little or no ability to set taxes, service fees and tax surcharges that they can use to meet locally determined needs. In the absence of this right, local government units often cannot meet local needs even when the local people themselves are willing to tax themselves to provide the funds. Our efforts in decentralization are designed to initiate a relaxation of the grip of the Central Government in these areas.

c. Training

2.26 Wherever appropriate within projects and sectors, as well as on a cross sectoral basis, USAID will plan appropriate technical training programs. Such programs are essential for development and technology transfer. One particularly important training area is economic management. There are some top flight economists in and out of government. There is very little depth. Moreover, residual East Bloc dogma, as distinct from solid analytic capability, is a major drag on policy-making.

d. Science & Technology

2.27 In the science and technology/technology transfer area, proposed USAID Science and Technology Office projects will assist Egypt in solving a variety of priority development to coordinating and



integrating applied research and development across a wide range of fields, including agriculture, health, population and industry. Dissemination of research results will be emphasized, in order to involve a broad audience of Egyptian and U.S. researchers, institutions and development extension agents in identifying problems and their solutions. In this way, not only will the solutions to development problems become more rapidly known and utilized but also ties among various research and extension organizations, both Egyptian and American, will be strengthened and expanded.

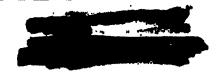
4. Commodity Import Program

- 2.28 The CIP has been and will continue to be an absorber of AID assistance. The results from a policy perspective have not been ideal. In essence, the CIP was intended to provide quickly disbursing balance of payments support: it was a "holding operation", a large absorber of AID funds until projects that had explicit merit on economic/social grounds could be developed. It has, in fact, become a crutch upon which the GOE is leaning heavily. Complete withdrawal of that crutch, especially during a renewed period of foreign exchange shortfall, would be non-productive from the point of view of U.S. Egyptian relations.
- 2.29 Nevertheless, there are opportunities to use the CIP to advance development objectives. In particular, we do plan to hold forthright discussions concerning the programming of the local currency being generated as a result of the sale of commodities imported under the CIP. For example, we may try to gain explicit GOE concurrence to reserving at least a part of the CIP-generated local currency to meet the huge local currency costs that would be associated with a major USAID effort in water/sewer infrastructure.
- 2.30 Over the longer term, we will indirectly seek a reduction in the level of the CIP by devising more development related programs that, given funding limits overall, would have to substitute for the CIP and that would appeal to the GOE on their development priority grounds.
- 2.31 Independently of changes in programming levels, the CIP increasingly will be used as a formal basis for policy discussions on cross sectoral issues interest rates, exchange rates, monetary and fiscal policies and the like. In addition, and for strategic purposes, we do need to be sensitive, especially at this juncture, to the "cash transfer" aspect of the CIP. It is fast disbursing and a politically important mode of support.

5. The Policy Dialogue

2.32 With respect to the policy dialogue, it clearly is worth emphasizing again that the largest share of Egypt's development constraints have resulted from policy mismanagement — even if many of the social objectives themselves were laudable. Given the policy management

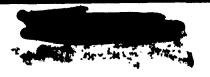




basis of many of the problems, it will only be through policy changes and their implementation that the problems will resolved. As such, USAID strategy includes a major role for the policy dialogue.

- 2.33 To be effective, our experience to date clearly indicates that the dialogue cannot be based on merely exhorting and "listing" the problems. On the contrary, a productive dialogue must lay out how USAID can be directly supportive of the "solution" to the problem, taking into quite explicit account how the adjustment burden of policy changes will fall on different sector of the economy and how that burden can be ameliorated and spread out over time.
- 2.34 Our approach to the policy dialogue will be based on these criteria. In part, the dialogue will use, as vehicles, "policy papers" that cover the major areas of our interest: energy pricing, food and energy subsidy policies, industrial reform and the like. In many cases, we have policy papers in relatively advanced stages of preparation. The choice of topics will be based on a range of practical considerations, including the volume of resources being misallocated on the basis of the "problem" area and the extent to which there are initiatives for reform being actively discussed and promoted within Egyptian society.
- 2.35 In view of the U.S. political commitment to support Egypt in our joint search for peace in the Middle East, USAID's leverage in the policy dialogue is limited to logic and persuasion. The direct extent of our leverage in allocating AID funds is to put them in areas with which we wish to be identified rather than the contrary.
- 2.36 Among Egypt's aid donors, only the U.S. and the World Bank have joined the IMF in the role of participants in the policy dialogue with the GOE. The other donors either are in the game with sums of money too small to play the role of policy advisor or are too concerned with using aid as an export promotion device (e.g., Japan and France) to bother about the broader questions. From the Egyptian perspective, the policy dialogue with the IMF will become intense only when Egypt is in urgent need of an IMF standby.
- 2.37 The World Bank, along with USAID, is taking a tough stance on energy pricing in negotiating future loans for energy generation and transmission. The Bank, as is USAID, is playing the role of researcher and persuader in the general area of comparative advantage, industrial development, and export promotion. Reflecting this, the title of the World Bank's forthcoming country economic review is "Egypt: Issues of Trade Strategy and Investment Planning."
 - 6. P.L. 480
 - a. Title I
- 2.38 P.L. 480 Title I has four objectives -- furtherance of U.S. foreign policy interests, disposal of U.S. surplus agricultural commodities, expansion of U.S. commercial sales, and economic

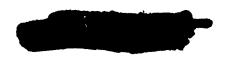
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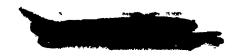
development. The contradictions that are inherent in such a range of objectives are readily apparent. It is these contradictions that complicate the use of the P.L. 480 program for economic development purposes per se and especially its use in the economic policy dialogue.

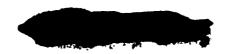
- 2.39 In the period FY 1975-FY 1982, the U.S. provided to Egypt just over \$1.8 billion in P.L. 480 Titles I and III assistance, supplying more than 12.4 million metric tons (MT) of wheat/wheat flour, 1.1 million MT of corn, and 102,000 MT of other grains. An additional \$110.8 million worth of commodities were provided under Title II.
- 2.40 P.L. 480 has been an important component of U.S. aid, representing over one-quarter, on average, of the total U.S. economic assistance effort. P.L. 480 annually has provided approximately 18 percent of all Egypt's wheat imports. Wheat imports, in turn, have represented in recent years over 60 percent (in value) of all of Egypt's food imports. (Another substantial part--recently, approximately 20 percent -- of Egypt's wheat/wheat flour imports also has come from the United States through direct commercial sales.)
- 2.41 The highly concessional nature of the P.L. 480 program normally should be expected to afford to the U.S. a degree of leverage over the recipient country's development policies, particularly those in the food and agriculture sector. However, the program has not been used for optimal development purposes, principally because the GOE is extremely sensitive about the use of "leverage" by aid donors to bring about policy change, and the U.S. thus has been reluctant to strain our political relationship by pressing for change using P.L. 480 (or any other component of the economic aid program) as an instrument. Nevertheless, self-help measures have been negotiated with the GOE in the past, and the dialogue with respect to the measures holds potential for orientating the GOE's policies and programs in the agriculture sector toward the development mode we have been seeking.
- 2.42 For the FY 1983 programs, USAID and the GOE have agreed that FY 1982 self-help measures essentially would be carried forward but that there would be quantitative indicators for assessing performance on those self-help measures. These indicators are being incorporated in a side letter of understanding.
- 2.43 The availability of cheap wheat in large quantities probably has been one of the factors that have allowed the GOE to avoid tackling price policy and subsidy issues. On the other hand, it is fairly clear that Egypt does not have a comparative advantage in wheat production and, therefore, the GOE should not take steps that result in the allocation of resources for the purpose of increasing wheat production. The GOE should, however, adopt measures that make production of wheat varieties producing higher grain yields (as opposed to straw for animal-feed) attractive, thus reducing incentives for production of red meat, a comparatively inefficient and costly use of grain. The GOE also should reduce wheat subsidies for consumers, which encourage over-consumption and diversion of wheat into feed.





- 2.44 It should be noted that the GOE's wheat price and import policies affect the incentives for production of other grains as well. Demand that normally would spill over from wheat to other grains is met at least in part by wheat imports.
- 2.45 In working to rationalize Egyptian policies, we will attempt to use a theme familiar to the Egyptians, "National Self-Sufficiency," to convince them that a) production of basic food crops, as well as high value food crops in which Egypt has a comparative advantage, should be pursued with vigor, and b) P.L. 480 and other imports should not be relied upon to meet Egypt's food gap, as their availability in the future always is subject to competing worldwide claims.
- 2.46 In a meeting on December 28, 1982, with Administrator McPherson, GOE Agriculture Minister Wally indicated his agreement that P.L. 480 is a "tranquilizer pill," and that domestic food production must be emphasized. As a means of reinforcing this latter approach, we are recommending a reduction of the value of P.L. 480 to \$ 225 million beginning in FY 1985, with reductions of \$25 million to be effected in each of the succeeding fiscal years. In the immediate future, the reduction in the dollar value of P.L. 480 does not necessarily mean a corresponding decline in Egyptian P.L. 480 financed imports. This will depend on wheat export prices and they have been falling.
- 2.47 With respect to the other objectives of P.L. 480, we agree with the findings registered in the informal report of the team headed by R. Blue, which studied the Egypt P.L. 480 program in February of 1982. The team finding regarding U.S. foreign policy objectives was that our food aid "helped the Government of Egypt implement its policy of freely-available bread for the masses, thus helping ensure the domestic stability without which the peace process could not have proceeded. The report went on to say: "Thus, it was not surprising that officials of the GOE described P.L. 480 as a critical element in the development of U.S. Egyptian relations." As to P.L. 480 Title I's role as an effective tool for development of a market for commercial sales of U.S. wheat and wheat flour, the team found mixed signals and finally concluded that "the decision to purchase commercially from the U.S. is determined primarily by price and availability considerations and not (by) the level of P.L. 480 Title I. This view was confirmed by the Egyptians." The report of the Blue team did not comment on P.L. 480's role in disposing of surplus U.S. wheat and wheat flour, but it is obvious that the program for Egypt makes a contribution in this area.
- 2.48 In conclusion, we agree that the P.L. 480 program should be used as part of the policy dialogue with the GOE, and we intend to do so, especially in negotiation and review of self-help measures and indicators. Nevertheless, while providing a forum or a context for discussion of policy issues, the program is not a particularly useful instrument for the exercise of leverage, for the reasons described above.





b. P.L. 480 Title II

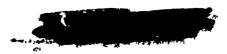
2.49 Title II is a development resource to be programmed in support of USAID and host country priority sector development goals. Our approach to ESF funded programs in the human needs area recognizes that gains in health, nutrition, family planning, and education come slowly; programs in these sectors are long term, systems and institution-building in nature. Our Title II program (and criteria for cash grants to Volags) is being redesigned to reflect this by sharpening the Title II focus, achieving a high degree of integration, developing local foods to replace Title II food components, and supporting Volag activities that promote indigenous food production. This will not preclude selective short-term targeting for an interim period.

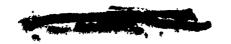
c. P.L. 480 Title III

2.50 Under a Title III agreement negotiated in FY 1979, \$75 million in Title III forgiveness was authorized on the basis of a five-year plan for infusing equivalent LE funds into continuing and new decentralization activities as the program expanded from nine to twenty governorates. FY 1983 is to be the last year of the Title III agreement, with \$15 million equivalent in LEs to be made available. The Mission does not plan at this time to request a new Title III authorization.

D. OTHER DONOR ASSISTANCE FLOWS

- 2.51 As measured by gross disbursements from Official Development Assistance (ODA) in Annex Table 14, recent trends in external donor assistance to Egypt are a mirror of the politics of the Middle East. Between 1976 and 1978, OPEC assistance to Egypt averaged U.S. \$1.5 billion per year and total assistance averaged U.S. \$2.2 billion per year. Following the Camp David Accords, assistance from OPEC virtually ceased. Reflecting the precipitous decline in OPEC assistance, aid flows to Egypt from 1979 to 1981, the last year for which ODA data are available, averaged U.S. \$1.4 billion. Of this amount, the U.S. provided over 50%. Since 1979, U.S. assistance flows have dwarfed assistance flows from other bilateral donors as well as flows from multilateral agencies, now mainly from the World Bank.
- 2.52 Certain aspects of these statistics, particularly the precipitous decline in OPEC assistance, are misleading. The large OPEC flows to Egypt were essentially a financial rescue operation. They enabled Egypt to pay off (amortize) debt to other Egyptian creditors. Thus, the OPEC flows did not represent a major infusion of new funds. They are more properly interpreted as a form of rescheduling, with OPEC "buying out" other creditor claims on Egypt. It is for this reason that the line item in Table 14 labeled Non-OPEC Aid Flows is a better indication of the buoyancy in aid resources that Egypt experienced in recent years: non-OPEC flows tripled between 1976 and 1981 and are now leveling off. Prospects for Arab aid in significant amounts are uncertain. The likelihood of any significant increase in aid, except for political purposes, is dim.

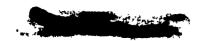


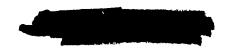


III. RESOURCE REQUIREMENTS

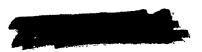
A. NARRATIVE

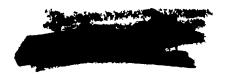
- 3.01 In support of the program strategies previously outlined, the Mission has prepared two separate resource requirements tables. The first (Text Table 3) reflects a straight lining of ESF and P.L. 480 Title I, at levels authorized in recent years, for the full CDSS period, FY 83 through FY 88. Previously programmed Title II reductions, however, are continued in this scenario. The second set of funding projections, AID/IDCA Declining Levels, (Text Table 4) shows P.L. 480 Title I dropping \$25 million a year beginning in FY 1985 and ESF dropping to \$650 million in FY 1986 and \$500 million and \$350 million respectively in FYs 1987 and 1988. Both of these scenarios reflect the three strategic imperatives outlined earlier in this paper.
- 3.02 The first imperative is to reduce the risk that the likelihood of a downturn in Egypt's performance will be unfavorably associated with the U.S. This imperative will be addressed by programs designed to create physically tangible and economically appropriate infrastructure to which the U.S. can point as positive benefits.
- 3.03 The second is to promote and support GOE policy reform initiatives that are essential for securing Egypt's development prospects. In part, we plan to respond to this imperative through programs in population, decentralization, institutional development and training. The institutional development and training components will be both specific to individual projects as well as being designed on a cross-sectoral basis.
- 3.04 The third imperative is to deflect into constructive channels Egypt's desire to convert the AID program into little more than a budget/balance of payments support facility. That, experience indicates, would only delay the reform efforts that are essential for relaxing Egypt's foreign exchange constraint. We plan to address this imperative by focusing on programs that are fully compatible with carefully selected priorities in the GOE five-year plan begining FY 1982/83. These programs will include both infrastructure development and sector-wide initiatives in industry and agriculture. Through this strategy, we hope to be able to contain the CIP component of the program to levels that, while meeting part of Egypt's immediate foreign exchange requirements, will not dominate the use of the program for purposes that are less developmental in character.
- 3.05 There are differences in funding levels in the two scenarios. One, as noted above, is essentially a straight line. We would, if this scenario prevails, attempt to structure the support largely in the direction of development needs, as distinct from overly concentrating on short-run balance of payments assistance. Operationally, the CIP level would be contained approximately to present levels.





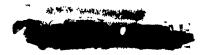
- 3.06 The second, or declining level scenario, allows for the possibility that the future evolution of political and economic factors will enable the U.S. to reduce its funding levels for Egypt. Should this scenario prevail, the CIP would bear the largest share of reduction in overall funding.
- 3.07 AID resources for the CDSS period are basically grouped against two classes of GOE economic requirements: short-term balance of payments (BOP) and longer-term discrete development initiatives. Title I and CIP programs, together constituting some 55% of all U.S. asistance, remain predominantly targeted against shorter term BOP considerations. The rest of the program is comprised of carefully selected longer term investments needed for development of the human, infrastructure and capital resource base that sustains productive economic development and enhances policy reform options.
- 3.08 In the BOP area, although it has proven difficult in past years to leverage any measure of policy reform from Title I programs, the Mission intends to give increased attention to this sub-goal through better and more quantifiable self-help measures and indicators. These will center on both price rationalization measures and removal of production, processing and marketing constraints. In future discussions with Egyptian leaders on the P.L. 480 program the Mission will continue to indicate that the U.S. cannot indefinitely support current levels of food aid and that future P.L. 480 allocations will take into account progress toward removing disincentives for agricultural production. In the aftermath of the York Report, there is increased awareness among Egyptian leaders of the degree to which current policies and practices are constraining output and eroding longer term prospects for food security. Title I self-help planning will be closely coordinated with design and implementation of both on-going and new agriculture ESF portfolio activities to ensure optimal impact on GOE agriculture sector planning and investment. Planned declines in Title I levels from FY 1985 onward are intended to reflect increased GOE independence in food security terms as improved pricing and implementation policies take hold.
- 3.09 Still in the BOP area, the Mission is projecting continued high CIP levels through at least FY 1986 to provide continuing support to the GOE during a period when it will be compelled to deal with sharply declining total resources. However, in this area also, the use of AID resources is being carefully structured to have an optimum development impact of its own and to reinforce that of the rest of the program. Mission strategy is to promote this in two ways.
- 3.10 First, at least half (and hopefully more in future years) of all CIP is being targeted away from strictly consumption and replacement requirements and toward the financing of materials and equipment that support gains in worker efficiency and production increases. Second, although agreement on the establishment of a Special Account for counterpart funds generated by CIP grants was reached in 1980 and a set of uses specified for the first LE 80 million, subsequent agreement on uses of some \$600 million of additional Egyptian Pounds has yet to be

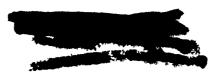




completed. In the absence of such an agreement, applicable funds have been in effect sterilized. The Mission is considering several options to negotiate with the GOE on use of these funds, including targeting most of them against the local currency requirements of AID-financed projects (especially in water and sewerage), and absorption of these funds into the general development budget in support of overall planning. In any event, the Mission intends to conduct a vigorous effort to integrate these funds with specific development planning and implementation activities. Reduced CIP levels in the out-years of the AID/IDCA Declining Levels table reflect a movement away from predominantly BOP-type support in favor of more longer term development and is posited on gains in the policy reform area during the early years of the CDSS period.

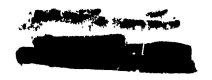
- 3.11 Beyond the BOP assistance provided through Title I and CIP, the Mission has annually a substantial amount of resources (some \$450 million from the Straight Line Level, Table 3) to program in a wide range of traditional development sectors. As has been noted throughout this document, AID strategy in selecting and implementing specific activities in these areas is limited by an all-pervasive set of unrealistic and counter-productive economic policies. AID's flexibility in determining the mix of activities and sector funding plans is constrained by simultaneous divergent forces: on the one hand, an effort to work within the current policy framework and, on the other, attempts to effect policy changes.
- 3.12 The Resource Requirements Tables group such activities under four headings: infrastructure, decentralization, basic human needs and production programs. The contents, policy constraints and rationale for selection of each of these plus the development sub-goals toward which they are individually targeted have been outlined in considerable detail in this document or its annexes and do not require further elaboration here. However, there are two unifying themes that link all these activities (and CIP and PL-480 as well) into the larger strategy for the CDSS period and merit recapitulation, i.e. policy reform and budget formulation.
- 3.13 In selecting areas of activity and in designing/implementing sub-activities, the Mission is seeking to relate closely to the new GOE five-year plan. To the extent that our initiatives are in lock-step with the government's own perceptions of its needs, we will be on strong grounds to pursue to their logical conclusion the policy issues posed. In this sense, working within the five-year plan is essential to placing the policy dialogue in a constructive, workable Egyptian framework. It must be recognized that the best chances for a successful policy dialogue are heavily dependent on Egyptian perceptions that they are leading it and that they are not being dictated to by foreign advisors. The Mission's selection of areas to fund is a careful blend of activities compatible with the policy orientation of our overall strategy, development needs, and the GOE's priorities as stated by the President and contained in the new five-year plan.





- 3.14 Implicit in the declining resource availability situation in which Egypt now finds itself are a host of budgetary considerations affecting the mix of government consumer programs and investments as well as the viability of existing and planned programs. Looming budget deficits threaten even further deterioration in already poor operation and maintenance capabilities and pose grave doubts as to the sustainability of existing, and the affordability of planned, programs. Mission plans and strategy must be responsive to these realities on two levels, the selection of individual activities to fund in such an environment and evolution of the budget process per se. As to the first, even though minimal new projects/activities are planned for the CDSS period, a careful review, in the light of emerging resource realities, of the budget implications (especially local currency) of each new and on-going activity is necessary. In particular, we are concerned with local financing requirements of the accelerated water and sewerage programs to which we agreed in principle during President Mubarak's January, 1983, Washington visit.
- 3.15 Beyond discrete AID-funded activities, the Mission is seeking to use discussions on individual activities and on uses of CIP-generated Special Account currency to highlight, as part of the policy dialogue, the need to use the budget process as a disciplinary and priority setting exercise as well as the need for movement to realistic price structures (e.g. utility rates) to relieve budget constraints. In the Declining AID/IDCA Levels table, ESF reductions in the out-years are most heavily against CIP, reflecting anticipated improvements in the GOE budget and allocation process as well as a Mission intention to center the remaining programs even more closely on development and policy reform considerations.
- 3.16 The large percentage of ESF funds that are committed to fixed on-going activities for the full CDSS period (\$550 million in CIP, water and sewerage and decentralization alone) in one sense limits the Mission's flexibility to factor in new activities, but in actuality these are such multi-faceted programs that considerable flexibility to modify them in implementation exists. Such modifications, particularly toward sector lending or budget support modes, primarily would be contingent on improvements in Egypt's economic policy framework.
- 3.17 In addition to the policy and budgetary constraints already mentioned as possible impediments to evolution towards broad sector programming, there is a nationally pervasive managerial deficiency which must be addressed. The efficiency of both public and private sector firms is adversely affected by a preponderance of senior company officers who are basically technicians with little or no management training. Strong management is the exception, e.g. the Suez Canal Authority and the Egyptian Electricity Authority. Further, in the case of public sector firms, emphasis is on meeting output quotas, with operating losses covered from the national budget. There is minimal incentive to operate efficiently or profitably. Consequently, awareness of pricing and organizational issues and their impact on overall output is low. Subsidized input and fixed output prices or service charges virtually





guarantee public companies monopoly conditions, masking management deficiencies and chilling the potential of private sector growth and the benefits of competitiveness. Thus, unlike private sector firms, the felt need for management improvements in most public sector firms is weak at best and virtually nil among service agencies, such as in water and sewerage, groups that are of particular concern to the Mission because of program plans for expanded activity. The Mission has fielded a number of activities aimed at this constraint both for company management and for overall government policy planning and intends to further strengthen these, particularly the latter, as an essential pre-condition to a more successful policy reform dialogue.

B. PERSONNEL REQUIREMENTS FOR THE CDSS PERIOD

| | <u>83</u> | <u>84</u> | <u>85</u> | <u>86</u> | <u>87</u> | <u>88</u> |
|------|-----------|-----------|-----------|-----------|-----------|-----------|
| USDH | 129 | 129 | 129 | 125 | 115 | 105 |
| FNDH | 96 | 96 | 96 | 90 | 85 | 80 |

3.18 Despite the greater degree of consolidation intended during the CDSS period the Mission retains immense obligation and implementation responsibilities under current AID requirements. Further, prospects for policy reform are uncertain. Thus, even under the declining levels scenario, reductions in direct hire staff levels cannot be accurately projected. What is likely is considerable regrouping of the personnel structure to reflect increased or decreased emphasis on particular areas. This regrouping combined with a decline in total numbers of projects as current portfolio activities are completed should permit modest personnel level declines as shown in table 5, above. If, however, significant policy reforms take hold as hoped for, draw-down of total staff numbers in the out-years could be still higher as less personnel intensive sector lending or budget support programs replace project initiatives. Furthermore, if certain changes in AID procedures can be effected and if a revised internal business implementation system can be developed to simplify management processes, it is possible that some minor personnel reduction may take place prior to 1986. In this connection, it should be noted that a few positions in the Mission staffing patterns already have been deleted.

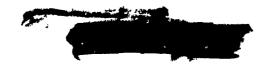




Table 3
RESOURCE REQUIREMENTS
STRAIGHT LINE LEVELS

| | | | | | | |
|---|----------------------|---|--------------------------------------|------------------------------|-------------------------------|---------------------------|
| | FY 83 | FY 84 | FY 85 | FY 86 | FY 87 | FY 88 |
| ECONOMIC SUPPORT FUND | | | | | | |
| I. COMMODITY IMPORT PROGRAM | 300 | 300 | 300 | 300 | 300 | 300 |
| II. INFRASTRUCTURE | 294 | 200 | 200 | 200 | 200 | 200 |
| A. Water And Sewerage | | | | | | |
| 0048 Canal Cities 0091 Cairo Sewerage 0100 Alexandria Sewerage - Water and Sewerage PAAD | (87) (30) (80) | - - - (200) | - - - (200) | - - (200) | - - - (200) | - - (200) |
| B. Energy | | | | | | |
| 0009 Ismailia Power - Unit # 4 | (97) | _ | - | _ | - | - |
| III. DECENTRALIZATION PAAD | ande General | <u>50</u> | <u>50</u> | 50 | <u>50</u> | <u>50</u> |
| 605.1 Dev. Dec. 605.2 BVS 605.3 Prov. Cities 605.4 Dev. Sup. Fund 605.5 NUS | | - (12.5) (12.5) (12.5) (12.5) | (12.5) (12.5) (12.5) (12.5) | (20) (20) (20) (10) | (22.5) (10) - (17.5) | (20) (10) - (20) |
| IV. <u>HUMAN RESOURCES</u> A. Basic Human Needs | 53.0 | <u>75.0</u> | 65.0 | 75.0 | 65.0 | <u>75.0</u> |
| 0015 Rural Health 0136 Suez Health | (4.5) | (2.6) (4.0) | - (2.6) | <u>-</u> | - | |





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Table 3 (continued) RESOURCE REQUIREMENTS - STRAIGHT LINE LEVELS

| | FY 83 | FY 84 | FY 85 F | 'Y 86 | FY 87 | FY 88 |
|--|-------------------------------|---|--------------------------|---------------------------------|---------------------|-----------------------|
| 0139 Basic Education 0144 Family Planning | (20.0) (20.0) | (3.4) (25.0) | | _ (19.2) | <u>-</u> | <u></u> |
| B. Workforce/Training | | | | | | |
| 0125 Workforce Planning | _ | (5.0) | (5.0) | (5.0) | (5.0) | (5.0) |
| C. Applied Tech/Tech Transfer | | | | | | |
| 0105 MPGWA 0115 Tax Administration 0118 University Linkages 0123.1 Energy-Policy/Planning 0123.2 Energy-Renewables 0123.3 Utility Management | (7.0) (1.5) - - - | (5.0) - (15.0) (6.0) (4.0) (5.0) | (4.5) - - (5.5) | - - - (13.3) (10.0) | - - - - | - - - - - |
| Section IV Funds to be Programmed | - | - | - | (27.5) | (60.0) | (70.0) |
| V. PRODUCTION PROGRAMS A. Industry | 79.5 | 125 | 125 | 125 | 125 | 125 |
| 0147 Prod. Credit 0159 Bus. Support 0101 Indus. Prod. - Industry Sector Support PAA | (50.0) (9.5) - D - | (30) - (15) (30) | (20) - - (55) | - - - (75) | - - - (75) | - - - (75) |
| B. Agriculture | | | | | | |
| - Sup. Agri. System PAAD 0079 Small Farmer Prod. 0132 Irrigation Management | 20 - - | (15) (25) (10) | (15) (5) (30) | (16) - (34) | (50) - - | (50) - - |

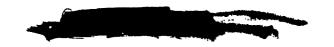


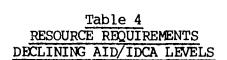


Table 3 (continued) RESOURCE REQUIREMENTS - STRAIGHT LINE LEVELS

| | | | | | | |
|---|-------------------|------------------|------------------|-----------------|-----------------|-----------------|
| | FY 83 | FY 84 | FY 85 | FY 86 | FY 87 | FY 88 |
| VI .OTHER | 23.5 | <u>0</u> | 10 | n | 10 | n |
| 0028 Grain Silos Overrun | (13.5) | <u>.</u> | | <u>0</u> ~ | <u>10</u> - | <u>0</u> - |
| 0102 Technical Cooperation (Pi | D&S) (10.0) | - | (10) | - | (10) | _ |
| ESF SUB-TOTAL | 750 | 750 | 750 | 750 | 750 | 750 |
| FOOD FOR PEACE (P.L. 480) | | | | | | |
| Title I - Of which Title III Title II | 250 (15) 14 | 250 (-) 12 | 250 (-) 12 | 250 (-) 8 | 250 (-) 8 | 250 (-) 8 |
| FFP SUB-TOTAL | 264 | 262 | 262 | 258 | 258 | 258 |
| TOTAL ESF PLUS FFP | 1,014 | 1,012 | 1,012 | 1,008 | 1,008 | 1,008 |







| | FY 83 | FY 84 | FY 85 | FY 86 | FY 87 | FY 88 |
|---|----------------------|---|---|----------------------|-------------------------------|----------------------|
| ECONOMIC SUPPORT FUND | | | | | | |
| I. COMMODITY IMPORT PROGRAM | 300 | 300 | 300 | 200 | 100 | _ |
| II. INFRASTRUCTURE | <u>294</u> | 200 | 200 | 200 | <u>200</u> | <u>150</u> |
| A. Water and Sewerage | | | | | | |
| 0048 Canal Cities 0091 Cairo Sewerage 0100 Alexandria Sewerage - Water and Sewerage PAAD | (87) (30) (80) | - - - (200) | - - - (200) | - - - (200) | - - (200) | - - - (150) |
| B. Energy | | | | | , . | |
| 0009 Ismailia Power - Unit # 4 | 97 | - | - | - | _ | - |
| III. DECENTRALIZATION PAAD | | <u>50</u> | <u>50</u> | <u>50</u> | <u>50</u> | <u>50</u> |
| 605.1 Dev. Dec. 605.2 BVS 605.3 Prov. Cities 605.4 Dev. Sup. Fund 605.5 NUS | | - (12.5) (12.5) (12.5) (12.5) | - (12.5) (12.5) (12.5) (12.5) | (20) | (22.5) (10) - (17.5) | (10) |
| IV. HUMAN RESOURCES A. Basic Human Needs | <u>53.0</u> | 75.0 | <u>65.0</u> | 75.0 | 65.0 | 75.0 |
| 0015 Rural Health 0136 Suez Health | (4.5) | (2.6) (4.0) | (2.6) | - | - - | <u>-</u> |





Table 4 (continued) RESOURCE REQUIREMENTS DECLINING AID/IDCA LEVELS

| | | FY 83 | FY 84 | FY 85 | FY 86 | FY 87 | FY 88 |
|------------------------------|---|-------------------------------|---|--------------------------|---------------------------------|---------------------|---------------------|
| - | | | 11 04 | 11 05 | | | |
| | Basic Education Family Planning | (20.0) (20.0) | (3.4) (25.0) | | | - - | |
| В. | Workforce/Training | | | | | | |
| 0125 | Workforce Planning | - | (5.0) | (5.0) | (5.0) | (5.0) | (5.0) |
| C. | Applied Tech/Tech Transfer | | | | | | |
| 0135 0118 0123 0123 | MPGWA Tax Administration University Linkages .1 Energy-Policy/Planning .2 Energy-Renewables .3 Utility Management | (7.0) (1.5) - - - | (5.0) - (15.0) (6.0) (4.0) (5.0) | (4.5) - - (5.5) | - - - (13.3) (10.0) | - - - - | - - - - |
| | ction IV Funds to be Programmed | - | - | - | (27.5) | (60.0) | (70.0) |
| V. A. | PRODUCTION PROGRAMS Industry | 79.5 | 125 | 125 | <u>125</u> | <u>75</u> | <u>75</u> |
| 0147 0159 | Prod. Credit Bus. Support Indus. Prod. Industry Sector Support PAAI | (50) (9.5) - - | (30) - (15) (30) | (20) - - (55) | - - - (75) | - - - (25) | - - - (25) |
| В. | Agriculture | | | | | | |
| | Sup. Agri. System PAAD Small Farmer Prod. Irrigation MGT | (20) - - | (15) (25) (10) | 15 (5) (30) | (34) - (16) | (50) - - | (50) - - |

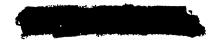




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Table 4 (continued) RESOURCE REQUIREMENTS DECLINING AID/IDCA LEVELS

| | FY 83 | FY 84 | FY 85 | FY 86 | FY 87 | FY 88 |
|---|---------------------|------------------|------------------|-----------------|-----------------|-----------------|
| VI. OTHER | 23.5 | <u>o</u> | <u>10</u> | <u>0</u> | 10 | <u>0</u> |
| 0028 Grain Silos Overrun 0102 Technical Cooperation (PD& | (13.5) S) (10.0) | - - | (10) | <u>-</u> | (10) | <u>-</u> |
| ESF SUB-TOTAL | 750 | 750 | 750 | 650 | 500 | 350 |
| FOOD FOR PEACE (P.L. 480) | | | | | | |
| Title I - Of which Title III Title II | 250 (15) 14 | 250 (-) 12 | 225 (-) 12 | 200 (-) 8 | 175 (-) 8 | 150 (-) 8 |
| FFP SUB-TOTAL | 264 | 262 | 237 | 208 | 183 | 158 |
| TOTAL ESF PLUS FFP | 1,014 | 1,012 | 987 | 858 | 683 | 508 |



MEMORANDUM

TO: See Distribution

FROM : NE/DP, Charles W. Johnson

SUBJECT: Egypt CDSS Review Meeting, Friday April 1, 2 P.M. in

Room 5951 NS

Introduction

The Mission is commended for the submission of a responsive and insightful document. The CDSS develops, in a logical fashion, the underlying U.S objectives, the economic environment, development constraints, the role of the Administrator's four initiatives, and the Mission strategy. The five annexes elaborate important components and themes in the Egyptian program.

In Egypt, government administrative control of the economy is an important development constraint. Over the years, AID strategy has been to encourage policy reforms through a combination of persuasion and program support. The assessment of the Mission is that progress in policy reform will be slow and difficult to achieve.

It should be recognized that between the limitations inherent in any bilateral relationship and the special limitations arising from the U.S. Egypt relationship, our possible impact on macro-level GOE policies is severely constrained. We probably will not decrease aid substantially in the absence of reform nor are we likely to increase aid as a reward for reform. Further, U.S. assistance probably is too small in toto - i.e., even if all of our assistance were converted to direct balance of payments support aid - to finance major structural reforms of the entire economy. (CDSS p. 27)

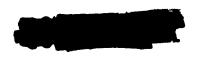
It is in this unfavorable economic environment that the Mission prepared its program. In the absence of policy reform the proposed CDSS strategy

avoids, to the extent possible, investment in sectors where our funding merely would serve to accentuate or prolong present policy-induced distortions in the economy.

In essence, we will be concentrating on relatively policy-neutral areas of the economy, laying a foundation for potential sustained economic growth. Aside from water and sewerage, these policy-neutral areas probably will include health, education, population, and science and technology. These latter areas are important not only from a basic human needs (BHN) standpoint but also on productivity grounds in that the provision of skills-training, equipment, and

DECLAS: 3/29/89





technology transfer will help the Egyptian to identify, prioritize, and solve their development problems effectively and efficiently. These emphases, however, will not preclude our selective support in the sectors of industry and agriculture where traditional cost/benefit analyses suggest that there are worthwhile opportunities. In addition, through the CIP and PL 480 programs, we will be providing balance of payments support to assist Egypt to meet its immediate economically-related political concerns. Both of these programs will be used, to the extent possible, to augment Egyptian investment in agriculture and industry, and both will be used, to the maximum possible extent, as instruments of our policy reform dialogue. (CDSS p. 26)

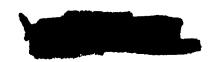
The following paragraphs are divided into two groups; issues and concerns. The former require Agency decisions of significant importance to the strategy and its implementation. The later, which do not require decisions, alert the Mission to discussions held at AID/W on various aspects of the CDSS.

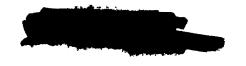
Issues

Issue 1 - Should the mission have a policy dialogue agenda for the productive sectors (energy, agriculture, and industry), which would identify the key GOE policy variables, desired policy reforms targets, and AID program responses when progress toward our goals is significant or the goals are met?

The FY 1985 CDSS strategy is a constrained strategy. It specifies USAID strategy assuming no GOE policy changes in its productive sectors and therefore concentrates on a core program of CIP (\$300 million) water and wastewater (\$200 million) and "policy neutral" projects (\$250 million). The latter are projects either in areas not distorted by GOE economic policies or projects in distorted sectors that do not reinforce the distortions. The former includes decentralization, basic human needs, and applied technology/technology transfer. The latter are production programs in agriculture and industry. The CDSS does not articulate the policy dialogue strategy for the productive sectors, nor does it present a program for these sectors that would be appropriate if satisfactory policy reforms are forthcoming.

A bewildering number of complex economic distort on confront those conducting the policy dialogue. Not surprisingly, progress has been greater in some areas than in others. There has been general agreement on the need for reform in the water and wastewater area and to a limited degree in power. Progress in the form of agreement with the GOE on what needs to be done and in what time frame, has been elusive in the agricultural and industrial sectors. The productive sectors are clearly too critical to Egypt's economic development to be excluded from active





AID involvement. The unanswered question in the CDSS is how the Mission proposes to advance from its constrained "policy neutral" projects to active policy dialogue and supporting programs:

Specific policy issues in each sector must be resolved before the Mission can develop the agendas or projects. A discussion of each sector follows.

Issue la - Energy

The current policy in energy, absent any significant energy price increases, is that we would not finance any new conventional energy generating capacity, but will continue to finance non-conventional energy, energy planning and utility management activities. We have advised the GOE that, if they are prepared to raise rates across the board by 24% this year, we would be prepared to provide financing for the Ismailia IV project. The CDSS has not articulated a strategy in this sector whether or not current discussions on Ismailia are successful, and there is no major energy capital financing contemplated beyond FY 1983. The long gestation period for project development in energy means that unless preliminary work has been done USAID would not be able to respond promptly to a GOE tariff stru. ure reform. There is also a commercial concern that without AID involvement in design efforts our existing commercial penetrations may be eroded.

Recommendation - The Mission prepare a program of continued involvement in the energy sector that is keyed to energy pricing reform.

Issue 1b - Agriculture

The current policy in agriculture has been to approve policy neutral projects and be prepared to fund a structural adjustment program of quick-disbursing resource transfers if farmgate prices are increased to world levels within five years. The CDSS refers only to the first part of the policy. The potential economic benefits of agricultural price rationalization are too valuable to be neglected.

Recommendation - The Mission pursue its policy dialogue on agricultural prices with the GOE and design variations in the offer of structural adjustment assistance that will bring the U.S. and GOE into agreement on the amount and timing of reform.

Issue lc - Agriculture, PL 480, Level of Assistance

What level of PL 480 should be planned? The Mission recommends that the level of PL 480 assistance be reduced by \$25 million per year beginning in FY 1985 to reach \$150 million in FY 1988.

Recommendation - The AID position is that PL 480 levels will decline by \$25 million per year through FY 1988.



Issue 1d - Agriculture, PL 480, Developmental Impact

Does the present strategy offer the best hope of maximizing the developmental impact of PL 480? USAID and the GOE annually agree on a set of self-help measures and reporting requirements. The CDSS states the PL 480 program should be used as part of the policy dialogue with the GOE... Nevertheless...the program is not a particularly useful instrument for the exercise of leverage." PL 480 sales to Egypt are undertaken as a form of development assistance and to maintain U.S. grain export markets. Improving the developmental impact of PL 480 may require a new strategy since (again quoting the CDSS) "The availability of cheap wheat in large quantities probably has been one of the factors that have allowed the GOE to avoid tackling price policy and subsidy issues." Alternatives to its current strategy could be: (1) set self-help performance targets with the understanding that future levels of PL 480 assistance will be linked to achieving the targets, (achieving targets could reduce the rate of phase down) or (2) focus less on policy issues and emphasize programming counterpart funds in a special account for development purposes.

Recommendation - USAID provide an assessment of the two options as against the current strategy and recommend its favored alternative in the ABS so that a strategy is developed well in advance of negotiations of the next PL 480 agreement.

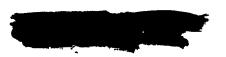
Issue le - Industry

The current policy in industry is similar to our agriculture policy. We approve policy neutral projects and projects that stimulate private sector investments in commodity production. In response to Egyptian urging that AID undertake an industry initiative the Administrator stated last December that AID would be willing to examine the possibility of U.S. emphasis on particular industries (which would almost certainly involve the public sector) on the understanding that our support of any project would be dependent on a belief that the selected industry could become more subject to market forces. For example, the public sector company in the chosen industry could establish an independent operating entity which would make its own independent economic decisions and be subject to conventional economic market forces. The CDSS states (p. 30) that the Mission "will attempt to devise terms of access that 'require' and even stimulate a more 'market forces' oriented public sector." The Mission identified financial credit as its main tool to commercialize the public sector in this "second-best situation".

The Mission has completed two studies, and the IBRD one, that indicate there is potential in small-scale private enterprises in both the productive and service sectors to help ease the unemployment problem. The CDSS does not indicate a role for small-scale enterprises in the development and expansion of the private sector.

Recommendation - The Mission articulate a policy dialogue approach to specify the critical GOE policy reforms in the public and private sectors

BEST AVAILABLE DOCUMENT



and AID programmatic response, especially a strategy for assistance to parastatals in the public sector and small-scale enterprises in the private sector.

Issue 2 - Do the urban-based initiatives, such as the Cairo Water and Wastewater Project, conform to the Urban Strategy described in the FY 1984 CDSS Annex?

More generally, does that urban strategy organize and guide the spatial aspects of project selection and planning? The FY 1984 Annex has guidelines for development intervention in urban areas. Since that time a major water and wastewater program has been introduced as a core element of the country program during the CDSS planning period. The CDSS does not articulate the relationship of this program to the approved Urban Strategy. The Urban Strategy should be the organizing theme of the urban-based projects, and their project documentation should demonstrate how they advance the strategy.

Recommendation - The next CDSS should include an overview of the Urban Strategy. This overview should provide an explanation of the principle elements and goals of the Mission's urban strategy and the means by which the water and wastewater program will contribute to achieving these goals.

Issue 3 - What strategy should AID pursue in Science and Technology?

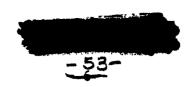
The current strategy can be characterized as one in which AID supports Egyptian researchers who perform "adaptive research"; that is they modify known technologies to make them useful in the Egyptian environment. The current technology transfer from the US to Egypt plays a major role in eliminating fundamental constraints to development. The adaptation and diffusion of these technologies are important stages in the development process. The Administrator has posed a question about the possibility of working in cooperation with Egypt on a fundamental research problem along the lines of basic research on leprosy being done in India. An issue is whether there are such research opportunities, and will their impact be larger?

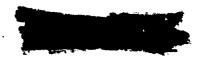
Recommendation - The mission continue its adaptive research strategy and remain sensitive to Egyptian goals in science and technology, including basic research.

Issue 4 - What will be the strategic emphases in health, education and human resources in the out years?

Are there sufficient policy-neutral investments to absorb the funds proposed? One-third of the requested funds in FY 1986 and nearly all of the requested funds in FY 1987 and FY 1988 are unprogrammed (CDSS Table 3, p. 42). The category of human resources includes basic human needs, workforce training, and applied technology/technology transfer. In Annex B of the CDSS there is a dicussion of health and nutrition,

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education and training, and population policies and their conformity with Agency policy, but no link between the policy discussion and the program funding level. For example, do the projects in basic education have their foundation in an education strategy or as consequences of a more general equity goal in the overall strategy? Recognizing that it is not always realistic to identify specific projects in the out years, it is nonetheless necessary to indicate the nature, importance and dimensions of the problems the Mission proposes to address and a link between development constraints, Mission strategies, and funding levels.

Recommendation - USAID provide subsector strategy statements, program goals and budget allocations for the out years in the ABS.

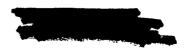
Issue 5 - What are the staffing implications (levels and skill mix) of the strategy outlined above? Are additional or different staff required to undertake the analysis indicated? Would action on polic reforms permit a near-term staff reduction?

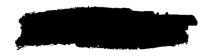
The CDSS states that significant policy reforms by the GOE tould reduce the Mission's personnel requirements as it shifts into less personnel-intensive sector lending or budget support programs. This would be in addition to the personnel requirement decline of 24 positions the Mission already proposes, which is derived from increased program concentrations. What is the basis for the belief that either policy reform or budget support programs will significantly affect staff levels?

Recommendation - The Mission needs to explain in detail the staffing implications that follow from the alternative strategies discussed above and the changes that would result from significant policy reforms. This should be submitted as part of the ABS.

Concerns

Fiscal Decentralization. Annex E states (p. 18) "...the most severe constraint to continuity [of the fiscal decentralization effort] is the absence, at present, of sizeable amounts of money to supplement AID funds and replace them in the long run." The Mission's assessment is that an inadequate tax base causes the constraint. The strategy to address this constraint is to fund projects on a sliding scale (AID contributions declining over time), encourage central government block grants rather than project-specific funding, and technical assistance to explore revenue generating options. Is this approach likely to be successful? Does the Mission have an assessment of how much revenue it is reasonable to expect local governments to raise given their economic base and tax laws?





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